PRACTICAL AUDITING

FIRST EDITION	.. .. ..	Published	1911
,,	(*Second Impression*) ..	,,	1912
,,	(*Third Impression*) ..	,,	1913
SECOND ,,	.. .. ..	,,	1914
THIRD ,,	.. .. ..	,,	1919
,,	(*Second Impression*) ..	,,	1920
,,	(*Third Impression*) ..	,,	1921
FOURTH ,,	.. .. ..	,,	1925
,,	(*Second Impression*) ..	,,	1926
,,	(*Third Impression*) ..	,,	1927
,,	(*Fourth Impression*) ..	,,	1929
FIFTH ,,	.. .. ..	,,	1930
,,	(*Second Impression*) ..	,,	1931
SIXTH ,,	.. .. ..	,,	1933
SEVENTH ,,	.. .. ..	,,	1938
,,	(*Second Impression*) ..	,,	1943
EIGHTH ,,	.. .. ..	,,	1945
,,	(*Second Impression*) ..	,,	1946
,,	(*Third Impression*) ..	,,	1947
NINTH ,,	.. .. ..	,,	1949

PRACTICAL AUDITING

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NINTH EDITION

BY

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LONDON:

H. F. L. (PUBLISHERS) LTD.

29, MINCING LANE, E.C.3.

1949.

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CHAPTER I

THE PRINCIPLES OF AUDITING

§ 1.—The Origin of Auditing.

The practice of auditing had its origin in the necessity for the institution of some system of check upon persons whose business it was to record the receipt and disbursement of moneys on behalf of others. In the early stages of civilisation the methods of account were so crude, and the number of transactions to be recorded so small, that each individual was no doubt able to check for himself all his transactions; but, as soon as the ancient States and Empires acquired any coherent organisation, records are found of systems of check being applied to their public accounts: the ancient Egyptians, the Greeks, and the Romans, all having utilised systems of check and counter-check as between the various financial officials.

The ancient records of auditing are confined principally to public accounts, but there is clear indication that from an early date it was customary for an audit of the accounts of manors and estates to be performed. The person whose duty it was to make such an examination of accounts became known as the auditor, the word being derived from the Latin *audire*, to hear. Originally the accounting parties were required to attend before the auditor who *heard* their accounts.

It was not until the 15th century that the great impetus given to trade and commerce generally by the Renaissance in Italy led to the evolution of a system of accounts which should be capable of recording completely all kinds of mercantile transactions, and the principles of double entry were first published in 1494 at Venice by Luca Paciolo, although the system had been more or less utilised during the preceding century. It thus became possible to record not only cash transactions, but all transactions involving matters of account, and the duties of the auditor correspondingly increased.

The increase in volume of trading operations, necessitating the use of more capital than was at the disposal of the average trader, induced him to combine in partnership with others for the purpose of obtaining the requisite capital, and this tendency was a potent factor in the evolution of a more perfect system of accounts.

In the same way no doubt it had a material effect on the practice of auditing, but the audit of business accounts did not become common until the 19th century. The enormous increase in trade in that period, which was fostered by the discovery of steam traction and by mechanical inventions generally, led to the formation of numberless Joint Stock Companies, and other corporate undertakings, involving the use of large sums of capital under the management of a few individuals. Under these conditions the advantages to be obtained from utilising the services of auditors became apparent to the commercial public generally, and a great increase in the practice of auditing resulted, until at the present day it forms the most important part of a professional accountant's business.

§ 2.—The Nature and Definition of an Audit.

It has been pointed out that an audit was originally confined to ascertaining whether the accounting party had properly accounted for all receipts and payments on behalf of his principal, and was in fact merely a cash audit; but the object of a modern audit, although it includes the examination of cash transactions, has as its ultimate aim the verification of the Balance Sheet of the undertaking; and, since the Balance Sheet must incorporate in one form or another the balance of the Profit and Loss or Revenue Account, the audit must extend to the examination of that account also.

An audit may then be said to be such an examination of the books, accounts and vouchers of a business, as shall enable the auditor to satisfy himself whether the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of the affairs of the business, and that the Profit and Loss Account gives a true and fair view of the profit or loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books; and if not, in what respects he is not satisfied.

It must not be implied from the above definition that the whole duty of the auditor is to compare the Balance Sheet and Accounts with the books in order to see that they agree therewith. He must do this, but he must also, by the exercise of reasonable skill and diligence, satisfy himself that the books themselves contain a proper record of the transactions entered into, as far as his information and the explanations given to him extend. This will involve a more or less complete examination of the whole of the transactions of the business, and the manner in which they are recorded.

How far such an examination must extend will depend upon the individual circumstances of each case, and must be decided by the exercise of the auditor's judgment. It is sufficient here to say that whatever the extent of the examination, it must be such as will satisfy the auditor, having regard to whether he is acting under the direct instructions of his clients or under Statute.

§ 3.—The Objects of an Audit.

As already stated, the main object of an audit is the *verification* of accounts and statements prepared by a client or his staff. Although of great importance, the detection of fraud and error must be regarded as incidental to such main object.

The prevention of fraud and errors by reason of the deterrent and moral check imposed is also an advantage of considerable importance which is derived from an audit.

(a) The Detection of Fraud.

In the minds of the public at large, and of many clients, the discovery of fraud is the principal function of the auditor, overshadowing his other duties entirely, and although this is far from correct, there can be no question that it is of primary importance.

Fraud may be divided broadly into two classes :

(1) Defalcations, involving either misappropriation of money or goods.

(2) The fraudulent manipulation of accounts not involving defalcation.

As regards the first class of cases, where accounting parties are not subjected to any form of check, the opportunities of committing fraud are so frequent,

and the methods necessary to conceal it so comparatively simple, that it is safe to say that no business of any size could be carried on under such conditions for very long without grave risk of fraud taking place. In small businesses where the individual proprietor is in touch with the whole of the detail, and is able to supervise it effectually, the possibilities of concealing fraud may be remote. As soon, however, as the business increases and the proprietor is no longer able to do this, if a check is to be maintained at all it must be carried out either by members of the staff themselves or by an outside auditor. Where the staff is sufficiently large to enable the whole of the work to be subdivided, so that the duties of every member of the staff come under the scrutiny of at least one other member who has had no part in the performance of those duties, what is known as an internal check comes into operation, and the first business of the auditor should be to examine carefully the system in force, and ascertain its deficiencies, if any. The strength of a chain is the strength of its weakest link, and the same may be said of a system of internal check.

The auditor, therefore, should pay particular attention to those classes of transactions which offer special facilities for fraud, the principal of which are cash transactions of one kind or another.

As general principles only are under consideration here, the actual way in which these transactions should be verified will be dealt with in due course, but it may be noted that there are two methods by means of which misappropriation of moneys may be concealed; the first by the inclusion of fictitious payments; and the second by the omission of receipts, the latter class being much the more difficult to detect.

The amount of detail checking which the auditor must perform before he can satisfy himself that no fraud exists, will depend to a great extent on the system of internal check in operation. Where that system is good, collusion between two or more persons must be involved before fraud can remain undetected. Collusion is not infrequent, and cases of it occur from time to time; but, though certain individuals may not themselves be inherently honest, they see the force of the proverb that "honesty is the best policy." Such a person might consider it more to his advantage, when approached by a fellow clerk with a view to collusion, to report the matter to his principals in order to gain the reward due to a faithful servant, than to participate in the fraud, and incur the risk of discovery, with its resulting consequences. The necessity for collusion, therefore, is a very great safeguard, and one upon which the auditor is entitled to rely. He must not of course do this indiscriminately, and assume that because there is a good system of internal check in operation he need perform no detail checking whatever. He must test the transactions as exhaustively as the circumstances permit, and should he find anything irregular he will then make a complete examination.

The second class of fraud, involving the falsification of accounts without corresponding defalcations, is naturally considerably less frequent than the class of fraud above-mentioned, but when it does occur it sometimes involves very large amounts. It may be done for the purpose of bolstering up a business which is in an insecure condition, in order to maintain the confidence of shareholders or the public; or it may be done by a manager for the purpose of increasing

the apparent profits of the business, thus showing that he has been successful in his management, and possibly increasing the commission on results payable to him; or by directors for the purpose of enabling them to pay dividends which would otherwise not have been possible. Several notable cases of this sort of falsification have occurred. It need only be pointed out here that this form of fraud is often very ingeniously and skilfully concealed, and is in many cases carried out by persons holding positions of the highest trust, and having the entire confidence of directors and shareholders.

(b) The Detection of Errors.

An advantage of considerable importance arising from an audit is the *detection of errors.* Often what appear to be in the first instance merely clerical errors, are ultimately found to be due to fraudulent manipulation, and it is therefore important for the auditor carefully to examine the cause of any error, however slight it may appear to be. The vast majority of errors, however, are *bonâ fide*, and due either to carelessness or ignorance.

Errors may be classified under the following headings:—

(1) Errors of Omission.
(2) Errors of Commission.

And these again may be classified as

(3) Clerical Errors.
(4) Errors of Principle;

while there is a further type known as

(5) Compensating Errors.

(1) *Errors of Omission.*

An *error of omission* arises when any transaction is left either wholly or partially unrecorded in the

books. If the former, the omission will not affect the Trial Balance, and will consequently be more difficult to detect. Sometimes it is apparent from the balance of an account that an entry has been omitted; *e.g.*, the Rent Account may show that rent for three quarters only has been paid, and no entry may have been made recording the quarter outstanding. This would become apparent as soon as the item of rent was compared with that of previous years, or the ledger account examined, but many other cases can be instanced which are much more difficult to deal with; *e.g.*, an item of purchases may be omitted, with the result that the purchases appear as less than they really are, and the creditors are similarly affected. This would not be disclosed by the Trial Balance, but might appear from an examination of the ledger account or the creditor's statement. Where only one aspect of the transaction is recorded, the omission will throw out the Trial Balance. This most frequently arises by reason of items not being posted.

(2) *Errors of Commission.*

An *error of commission* arises when a transaction is incorrectly recorded, either wholly or partially. In the former case the Trial Balance may not be affected, but the error should be discovered when the transaction is vouched or otherwise checked; *e.g.*, an entry in a Sales Day Book might be made, and the calculation of the value of the goods incorrectly extended. The posting of the incorrect item would be made to the ledger, and the error would not be discovered until either the calculation was checked or notice received from the customer. If the transaction is partially incorrectly recorded, the result will be to throw the Trial Balance out to that extent; *e.g.*, where

an item in the Sales Day Book is posted incorrectly to the ledger.

(3) *Clerical Errors.*

A *clerical error* is one occasioned by an incorrect posting; or by posting an item to a wrong account, but one of the same class to which it should have been posted; *e.g.*, an item might be posted to the debit of A instead of to the debit of B. If therefore the Trial Balance is agreed, all clerical errors of the first kind should have been discovered, unless they are counter-balanced by other errors. Clerical errors of the second kind, even if undetected, should not affect either the amount of profit or the general correctness of the Balance Sheet.

The following are common instances of clerical errors which the auditor should be on his guard against when engaged on books prior to the Trial Balance being agreed:—

(*a*) An item may be posted to the debit instead of to the credit of an account, or *vice versa.* This will throw out the Trial Balance to the extent of double the amount in question; *e.g.*, an item of £3 posted to the debit instead of to the credit will have the effect of making a difference of £6 on the Trial Balance.

(*b*) An item of £26 9s. may be posted as £20 6s. 9d. This will make a difference of £6 2s. 3d. in the Trial Balance. This is a very common class of error, and if the difference on the Trial Balance is susceptible of being interpreted in this or a similar manner, all items in respect of which such an error might arise should be re-checked.

(*c*) Although the casts and postings in a ledger account may be correct, the totals of the two sides of the

account may not agree, and consequently the balance of the account will be incorrect. In casting ledger accounts and checking down balances a junior audit clerk is frequently apt to omit to see that the totals on the two sides of the Ledger Accounts agree.

(*d*) Errors often arise in carrying forward totals from one page to another; *e.g.*, £300 10s. being carried forward as £310, or £189 as £198.

(4) *Errors of Principle.*

An *error of principle* arises by reason of a transaction being recorded in a fundamentally incorrect manner. This is the most important class of error, and one which the auditor should exercise the utmost care to detect.

Minor errors of principle may not affect the ultimate profit, but arise from revenue items being posted to the wrong class of revenue account; *e.g.*, an item of manufacturing wages being posted to Trade Expenses Account; or may consist of Balance Sheet items being posted to the wrong class of asset or liability accounts respectively.

Major errors of principle directly affect the profit, and are occasioned by treating a revenue item as an asset or a liability, or *vice versa*; *e.g.*, treating rent paid as a debtor instead of an expense.

(5) *Compensating Errors.*

A *compensating error* is one which is counterbalanced by another error or errors, so that it is not disclosed by the Trial Balance. This is a dangerous type of error, which is sometimes difficult to detect. It may or may not affect the profit. If the original error and the compensating error both arise in revenue

accounts, the profit will not be affected, but if one arises in a revenue account and the other in an asset or liability account, although the Trial Balance will agree, the profit will be incorrectly stated. Such errors arise in various ways, but most frequently in casting; *e.g.*, the cast of an expenditure account is £100 too small, and the cast of an asset account is £100 too much, the profit and the assets being thereby increased improperly.

§ 4.—Various Classes of Audits, and their Advantages.

It may be convenient here to indicate the principal classes of audits which are undertaken in practice, and the advantages to be derived therefrom.

(a) Audits under Statute.

Audits are compulsory under Statute in the case of a large number of undertakings, chief amongst which must be placed limited companies. The regulations as to the appointment of auditors and their duties in each of these cases will be dealt with in due course; but the advantages to be derived by the shareholders and proprietors of these concerns, from a professional audit, are similar in their nature, and may be dealt with from the general point of view of limited companies.

It has already been noted that trading partnerships arose by reason of the development of trade requiring the utilisation of more capital than was at the command of the individual trader; and, in the same way, joint stock companies supplied the machinery for utilising, under one management, larger amounts of capital than could be provided by either

individuals or partnerships. Such companies operated originally under partnership law, and the liability of each of the members was unlimited. It was impossible, however, to obtain efficient management, and at the same time to permit each individual shareholder or partner to exercise the rights of an ordinary partner, and, as a result, committees of management were formed, in whose hands the whole of the operations of the undertaking were placed. Such persons became known as the directors.

As a result of their position, directors found themselves in a fiduciary relation to the body of shareholders, and liable to account to them for all their dealings on behalf of the company.

The number of companies of this nature having increased very largely, special legislation on the subject was found to be necessary, and in 1844 the Joint Stock Companies' Registration Act was passed. At this period the liability of each shareholder was unlimited, and it was not until 1855 that the first Act was passed making it possible for shareholders to limit their liability. Several other Acts were passed amending the law on the subject, and in 1862 the law was consolidated in an Act, as a result of which joint stock enterprise increased very rapidly.

The fact that the whole control of the company was vested in the directors, rendered it necessary that some means should be utilised for enabling the shareholders to be assured that the accounts presented to them by the board correctly represented the state of affairs of the company, and that the directors had not utilised their position for the purpose of misappropriating the funds of the company or using them for their private gain. It was impracticable, however,

for every individual shareholder to satisfy himself on these points, for as a rule he was not possessed of the requisite technical knowledge, and the right of inspection and inquiry could not be given to one shareholder without it being granted to all. Consequently it became usual for shareholders to appoint one or more of their number to act as auditor or auditors of the company, and to report to the shareholders on their examination of the Balance Sheet and accounts. Subsequently it was found inadvisable to confine this function to individual shareholders, who might not be possessed of the requisite qualifications, and it became usual to appoint professional auditors to act on behalf of the shareholders generally. Although for some considerable time the lay auditor continued to exist, he is now rapidly disappearing, and the accounts of practically every company of importance are now audited by professional accountants.

Notwithstanding this tendency, which had manifested itself early in the history of joint stock enterprise, it is curious to note that the Act of 1862 did not make any provision for the appointment of an auditor, or for the presentation of accounts to the shareholders, except in-so-far as this was done in the Schedule to the Act, known as Table "A," which contained a model set of Articles to be utilised by all companies not possessing Articles of their own. These regulations contained provisions for the appointment of auditors and the presentation of accounts, and although the Table did not apply to companies whose Articles expressly excluded its operation, it became customary for all companies to make provision by their Articles for the appointment of an auditor. It was not, however, until the Companies Act, 1879, was

passed that any further statutory reference was made to the appointment of auditors, and this Act only referred to banks registered after the passing of the Act, an audit in these cases being made compulsory. This provision was not extended to all limited companies until the Companies Act, 1900, when for the first time it became legally necessary for every limited company to appoint an auditor or auditors.

The Companies Act, 1907, amended the duties of auditors as defined in the Companies Act, 1900, and the Companies (Consolidation) Act, 1908, repealed and re-enacted the whole of the Statutes relating to limited companies, and consolidated the regulations relating to the audit. These provisions were substantially unaltered by the Companies Act, 1929, but the duties of auditors were extended by the Companies Act, 1948.

The advantages of a professional audit of a company's accounts from the point of view of the shareholders are manifold. It has already been pointed out that it is impossible for individual shareholders to be familiar with the details of all the various businesses in which they may be interested as shareholders; moreover, the Articles of companies do not as a rule permit individual shareholders to have access to the books and accounts; and consequently, the shareholders as a body are entirely dependent on the auditor appointed by them, whose duties are to examine the books and accounts of the company, and report to them on every Balance Sheet and Profit and Loss Account laid before the company in general meeting. In addition, the audit acts as a check upon the directors, and as a precaution against fraud on the part of employés. Moreover, the auditor is often able to render valuable assistance, by reason of his expert

knowledge in matters of account and finance generally, although it is not within his province to offer advice unless he is asked for it.

In this connection, the functions of the auditor as apart from the accountant should be distinguished. It is commonly the custom, particularly with the smaller classes of companies, to arrange for the auditor to prepare the final accounts. If he does this, it should be remembered that he acts in his capacity as accountant, under the instructions of the directors, and not in his capacity of auditor appointed by the shareholders. He may perform other duties than those mentioned, in his capacity of accountant, but in all instances of importance it would seem advisable that he should acquaint the shareholders that he is acting in this manner as well as in the capacity of auditor. It would then be for the shareholders to decide whether he shall continue so to act or not. This particularly applies to cases where the auditor also writes up the books of the company.

(b) The Audit of the Accounts of Private Firms.

The audit of trading partnership accounts has become increasingly frequent as the commercial community have realised the advantages to be derived therefrom. It should be remembered that such duties are not performed under Statute, but under the partnership agreement, or by mutual agreement between the partners, and it may be useful to note the essential distinctions between the audit of a company and the audit of a private firm. The former is obligatory under Statute, and the rights and duties of the auditor are defined by Statute ; he is appointed by the shareholders, or by the directors on their behalf in certain instances, but they cannot limit his statutory

duties, though they can, if they wish, extend them. In the case of a private firm the auditor is not appointed under Statute, but by agreement between the partners, and his rights and duties are defined by them, and are subject to modification.

In the case of private firms, the auditor frequently acts also in the capacity of accountant, and although it may be possible for him to distinguish accurately between the work he performs in each of these capacities, the distinction may not be regarded in the same light by his clients. Frequently, where only accountancy work is performed, the client supposes that his books are actually audited, and the responsibility for errors and fraud may in this way recoil upon the accountant. In order to avoid this, the precise duties of the accountant should be carefully defined in writing at the outset, so that no dispute can subsequently arise as to the extent of his responsibility. This subject is further dealt with in Chap. X, § 4, where legal decisions are considered.

In addition to the advantages common to all forms of audit, *viz.*, the verification of accounts and the detection of errors and fraud, the audit of partnership accounts is advantageous, inasmuch as it affords a convenient means of settling accounts between the partners themselves, and so of avoiding the possibility of future dispute. It is customary to find provisions in partnership agreements arranging for an audit, and making the audited Balance Sheet, when accepted and signed by them, final as between the partners.

The suggestions which the auditor is sometimes able to make with regard to the improvement of the

system of accounts in use, and the expert knowledge of accounts at his command, should also prove of advantage to the business.

The settlement of accounts resulting on the death or retirement of a partner, or the adjustments arising on the occasion of an incoming partner, are much facilitated when audited accounts form the basis upon which to work; and the same remarks apply to the assessment of the firm for taxation, the necessary adjustments relating to the individual partners, and the preparation of their Income Tax returns. The growing complexities of taxation law make the advantage of professional assistance in this matter particularly noticeable, since an indifferent knowledge of the procedure may result in considerable loss to the taxpayer.

The sale of the business as a going concern, or the negotiation of loans with banks and others, are considerably facilitated where proper accounts have been prepared and audited.

An audit on behalf of a sleeping partner is very advisable, since such a person, as a rule, has little means of checking the accounts of the business, or verifying the share of profits due to him.

In the case of individual traders, the arguments in favour of an audit are similar to those above set out, with the exception of the points applicable only to partnerships. In a business of any size, the absence of partners and the impossibility of one man being assured of the correctness of the whole of the detail of his business, render it all the more essential that he should employ professional accountants for this purpose.

(c) The Audit of the Accounts of Private Individuals.

It is becoming customary for persons whose incomes are considerable, and whose expenditure is heavy, to have their private accounts audited. Frequently the auditor in such cases also acts as accountant, and actually writes up the books.

The advantages to be derived from an audit of this nature are, in the first place, that the individual is assured of having his accounts properly kept and his expenditure vouched. These considerations particularly apply where the expenditure is incurred in respect of landed property, or the upkeep of large establishments, when it is practically impossible for the proprietor to control personally the payments made. He is obliged to place his trust in individual agents or servants, and to give them the control of moneys, and unless an efficient check is exercised upon their actions the temptation to defraud is considerable. Secondly, the presentation of accounts prepared on a uniform basis affords a valuable means of comparison of the various classes of expenditure between one year and another, and where such expenditure exceeds the limits of prudence, it is possible immediately to ascertain the origin of the increase, with the result that steps may be taken to rectify the position. The preparation of Income Tax returns is also greatly facilitated.

In addition to the cases above-mentioned, there are many other instances where agents are appointed for the purpose of controlling business operations, and the value of an audit to the principal concerned is particularly apparent when he has no effective check on the accounts of his agent. Instances of this class of audit are: the audit of the accounts of an

Inderwriting Agent at Lloyd's, and the accounts of ent collectors, estate agents, etc.

Private books of account are very useful to xecutors and administrators of a deceased person, nd when these books are properly audited they are oubly valuable, inasmuch as the executor knows hat they can be relied upon. They will form the asis for the preparation of the Estate Duty Account, nd will save very considerable trouble and expense, which would otherwise be incurred if no proper ecord had been kept of the assets and liabilities of he deceased. Owing to the failure of a person to keep roper books of account during his lifetime, great ifficulty is often experienced in ascertaining what ssets the testator actually died possessed of, or the xtent of his liabilities.

1) **The Audit of Trust Accounts.**

The accounts of executors and trustees furnish he occasion for another class of audit, the advantages f which have been more appreciated in recent years y the general public.

In the majority of cases executors and trustees re private persons, sometimes possessing considerable usiness capacity themselves, and sometimes possessing one at all. The law relating to the administration f trusts is very complex, particularly in relation to natters of account. The two classes of beneficiaries—enants for life and remaindermen, to whom the ccuracy of trust accounts is of supreme importance—re often widows and minors, who cannot criticise the ccounts in any effective manner. In a great many ases also the trustees themselves present no accounts t all until forced to do so, and even then such accounts

are, as often as not, incorrect. In other cases the trustees keep no proper accounts, and this omission often serves to conceal misappropriations of trust moneys.

For these reasons the advantages of a professional audit of trust accounts, and of a strict verification of the securities composing the trust are apparent, but until the Public Trustee Act, 1906, came into force, it was very difficult to obtain such an audit, unless with the consent of the trustees themselves. The increasing number of scandals, some of great magnitude, arising from the defalcation of trust moneys, led to the passing of this Act, and the constitution of a Public Trustee. The only point of the Act, however, which need be emphasised here is that which provides machinery for the audit of the accounts of any trust, whether commenced before or after the passing of the Act, and whether the Public Trustee is or is not connected with it. An auditor appointed in such a case must either be a solicitor or a public accountant.

It may be noted that banking companies, insurance companies, and other corporate bodies have within recent years taken power to act as executors and trustees, and recognising the advantages of a professional audit to the beneficiaries, usually arrange that this shall be performed as one of the conditions on which they are prepared to undertake the trust.

Private trustees also recognise the advantages of an audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor, and can then be rectified. Further, they are able to consult the auditor on points of difficulty before action is taken.

§ 5.—The Conduct of an Audit.

(a) Continuous and Final or Completed Audits.

An audit may involve the whole of the transactions in the books being checked, when it is known as a "Complete" Audit; or it may involve checking only some of the transactions, when it is known as a "Partial" Audit. This latter term is incorrect, since any audit worthy of the name must be complete in the sense that the auditor must satisfy himself as to the correctness of the accounts he is asked to verify. In most businesses of any size, however, the amount of detail is so voluminous, and the time involved in checking the whole of it would be so excessive, that reliance for the accuracy of the detail is, to a large extent, placed upon the system of internal check in operation in the office itself, and the auditor, after making such tests of the detail work as commend themselves to his judgment, is then able to devote his attention to questions of principle.

In any case the audit may be carried out either continuously, at fixed or unfixed interim dates, or wholly after the completion of the period under review.

(1) *Continuous Audit.*

A continuous audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; such audits are adopted where the work involved is considerable, and have many advantages in their favour, although they are subject to certain disadvantages.

The following are the advantages of a continuous audit :—

(1) More detail checking can be performed.

(2) The work is checked sooner than would be the case otherwise ; errors can be rectified more quickly ; and if any fraud has taken place it is discovered sooner. In the latter event there is less time for the defrauding party to operate, with the result that the amount involved may be considerably less than would have been the case if the audit had not taken place until after the end of the financial period.

(3) The audit can be completed more quickly, and the accounts presented at the end of the financial year sooner than would otherwise have been possible.

(4) The frequent attendance of the auditor has the effect of causing the staff to keep the work well up to date.

(5) Where the attendance is at uncertain intervals, the moral check involved is considerably strengthened, as the members of the staff are not aware, from day to day, when the auditor will attend.

The following are the disadvantages of a continuous audit :—

(1) It is possible for figures to be altered, either innocently or fraudulently, after the auditor has checked them.

(2) The audit not being carried on consecutively to a finish, it may be possible for the clerk in charge to lose the thread of the work, and omit to follow up completely transactions

which may be left open at the date of his last visit.

These disadvantages, however, can be guarded against in such a way as will minimise the risk involved. A strict rule should be instituted, that no alteration should be made in any figures after the auditor has once passed them, but that, if necessary, adjusting entries should be made to rectify any error discovered. The fraudulent alteration of figures is somewhat difficult to provide against, and it is advisable for the auditor to adopt a special "tick" in cases where he checks figures that have been erased or otherwise altered, so that on a subsequent occasion he can see that the new figures are the ones actually seen by him. Such alteration in the "tick" should be extremely slight, and be kept secret, though it is to be feared that a clever manipulator would be sufficiently ingenious to discover this arrangement and imitate the "tick."

Fraudulent manipulations in personal accounts can most easily be concealed by making compensating false entries in impersonal accounts. It is of the utmost importance, therefore, in the case of a continuous audit, for the auditor to make certain that no "juggling" can take place with the impersonal accounts which he has already checked; and for this reason, where, as in most cases, the impersonal accounts are not excessively voluminous, it may be wise to leave the checking of these accounts until the final Trial Balance is arrived at and the books closed. The work done during the interim period is usually connected with the vouching of the cash, casting of subsidiary books, and work on the Bought and Sold Ledgers, etc.

In some cases it may be inconvenient to leave the impersonal work in this way until the end of the period, and, in that event, unless the Impersonal Ledger is balanced off at the interim periods (which is unusual), the auditor should take a note of all the totals in the Impersonal Ledger up to the date to which he has checked it, and verify these totals on the occasion of his next visit, in order to see that no manipulation has taken place.

The disadvantage arising from the lack of continuity in the work, and the possibility of points being overlooked in consequence, can be remedied by the exercise of proper care and supervision in the conduct of the work, aided by a judicious use of notes where necessary.

(2) *Final or Completed Audit.*

A final or completed audit is commonly understood to be an audit which is not commenced until after the books are closed at the end of the financial period, and is then carried on continuously until completed. This is the most satisfactory form of audit from the auditor's point of view, and is usually adopted wherever practicable, particularly in the case of small concerns. In large businesses, however, the amount of time occupied by the audit after the completion of the accounts is so considerable as to delay the presentation of the final audited accounts beyond a reasonable period, and thus defeats one of the advantages of the audit, *viz.*, that the accounts shall be audited and reported on as soon as possible after the close of the financial year, in order that the information derived in this way can be utilised for the advantage of the business.

The proprietors are usually anxious for the audit to be completed as soon as possible after the financial year, and this is rendered essential in the case of limited companies, in order that the shareholders' meeting may be held and final dividends declared.

It has been suggested that the most advantageous form of audit is to have an interim or continuous audit performed by one auditor, supplemented by a final audit performed by another, though this is prohibitive in most cases, owing to the expense involved. The principle, however, is carried out in theory to a large extent in businesses of any magnitude, where an internal audit staff is employed by the proprietors, whose duties are distinct from those of the book-keepers, and who spend the whole of their time in checking the detail work. This represents the highest development of the principle of internal check, and is known as an internal audit, although it has not the same relative value as a detailed audit by outside auditors. Nevertheless, its efficiency is undoubted if it is properly organised.

(b) Considerations on the Commencement of a New Audit.

On undertaking a new audit, the first care of the auditor should be to ascertain the precise nature and scope of his duties. In the case of an audit under Statute, the question of the precise nature of the audit required by the client does not arise, but in other cases the line between accountancy work and audit work proper is sometimes so uncertain, at any rate in the minds of clients, that it is advisable for the auditor to ascertain in the first instance exactly what his client requires, and to take care that this is formulated in writing, especially where the audit is not a complete one.

This information having been obtained, the next step should be to ascertain the precise nature of the business carried on, in order to obtain a picture of what the books should contain. The auditor should then make a careful examination of the system of accounts employed in the office. A complete list of all books in use should be obtained, and where there is a definite system of internal check in operation, the auditor should ask for a written statement regarding it.

The names of the principal officials should also be obtained, together with particulars of the work controlled by each, and the scope of the authority.

From a first general examination of the books, in conjunction with the above information, the auditor will be in a position to formulate the principal lines on which the audit must be conducted, and the direction these will take will bear directly on the efficacy or otherwise of the system of internal check.

Taking as an instance the case of a manufacturing business, the special points to which the auditor should direct his attention in this connection are as follows :—

(1) The regulations in force relative to the receipt and payment of cash, and the cashier's duties; and particularly whether he is concerned with the writing up of other books of prime entry.

(2) The methods employed in the preparation of the wages sheets, and the manner of payment.

(3) The regulations in force with regard to the passing and checking of invoices and statements.

(4) The method of keeping and controlling the petty cash.

(5) The manner in which the entries in the Personal Ledgers are checked, and the balances agreed; the intervals at which the balancing is effected; and, in the event of each ledger being balanced separately, whether the Total Accounts are kept beyond the control of the ledger clerk concerned.

The opening Balance Sheet will be examined by the auditor, and the whole of the balances comprised in it should be checked in order to make certain that the period commenced with the balances as shown in such Balance Sheet. If the accounts have been subject to prior audit, the late auditor's report should be seen, as it may contain material information.

In the event of the business concerned being of a technical nature with which the auditor is unfamiliar, he must acquaint himself as far as possible beforehand with the technical details, so that he may be in a position to ask intelligent questions. It is clear that no audit can be effective unless the auditor himself grasps the nature of the transactions recorded, and it is essential, therefore, for him to make himself intimately acquainted with the procedure, by following through representative transactions of each class until he has succeeded in acquiring the necessary knowledge.

Special considerations arising on the occasion of the first audit of a limited company will be dealt with in Chapter VII.

(c) Audit Note Books.

There is a certain amount of difference of opinion among practising accountants as to the advantages to be derived from the use of Audit Note Books. In a properly organised office, it is essential that the principals should be perfectly familiar with the work

performed on each audit, so that in the event of the clerk in charge being away or leaving the firm, no difficulty need be experienced in carrying on that particular matter.

It is therefore desirable that some definite record should be kept of the work performed at each audit, and in order to ensure uniformity, and to make certain that all the work is done which should be done, it is advisable to make out a programme of work, the clerk responsible for each portion of the work done initialling as it is performed. In this way the progress of the work in the course of the audit can be ascertained immediately by the principal, and in the event of work being left undone, or errors being passed or made, the responsibility can be allocated to the particular clerk concerned.

On the occasion of the first audit it is not advisable to draw up a hard-and-fast programme, as the work to be done can really only be decided on as the audit proceeds. Careful note, however, should be taken of the work performed, and this will afford material for the preparation of an Audit Programme to be followed in the future.

The principal argument advanced against this procedure is, that by laying down a definite plan of work, the initiative of the clerk in charge is to a large extent nullified, and the audit is apt to become too automatic in its nature. There is no reason, however, why this should be so, as there is nothing to prevent the clerk in charge from making suggestions for amending the programme, and he should be *encouraged* to do so where his experience shows this to be desirable.

As long as the audit is not allowed to become too automatic, and the programme is changed or revised

from time to time according to circumstances, the system suggested has so many advantages that in a business of any size it can hardly be dispensed with in one form or another.

The practice of making notes during the progress of the audit, apart from a record of the work done, should not be extended further than is absolutely necessary. It is infinitely preferable to clear up a query and to get rid of it, than to make a note of it. Those points, however, which cannot immediately be cleared up must be noted, and an instance of this may be found in the case of missing vouchers, duplicates of which may have to be obtained.

Points of importance also which require to be remembered from one audit to another, but which are not apparent on the face of the accounts, should be recorded.

On the occasion of the first audit of a business which is of a technical nature, and where special considerations apply, it is very convenient to make explanatory notes of all transactions of technical difficulty, so that these can be referred to by others who may have to take up the work subsequently.

(d) Method of Work.

The method of work to be adopted on any audit will naturally vary with the individual training and experience of the auditor, and with the circumstances of each case. There are, however, one or two points which may be conveniently noted here.

Special " ticks " should be adopted for each class of transaction checked, and the following are the usual classes of " ticks " :—(1) Posting, (2) Casting, (3) Carry Forward, (4) Vouching, (5) Pass Book, and (6) Contras.

The same kind of " tick " is not used by every firm for the same transaction, nor is this perhaps desirable, but a rule should be made in every office that the system of " ticks " adopted must be closely adhered to, and not explained to a client's staff. It is usual for the auditor to use some coloured ink, such as violet or green, in order to distinguish his " ticks " from those utilised by the office, and usually colours are changed to distinguish periods.

Each section of the work should be completed, as far as practicable, and cleared definitely to a certain point. The habit of leaving " loose ends," which is a common failing with some audit clerks, is a very dangerous practice, as it may lead to points being ultimately forgotten or overlooked, or even possibly to fraudulent alterations being made. Fraud has been known to occur where the ledger balances had been checked one day and not cast till the next, the schedules having been in the meantime handed back to the ledger clerk, who had taken the opportunity of altering the figures already checked by the auditor. If the casts had been checked in the first instance this could not have occurred.

In the case of continuous audits, the work should only be performed up to a fixed date to which the books have been completed. In no case should pencil figures be taken. The practice of making pencil entries or casts is extremely undesirable, and the auditor should insist that all such entries are inked in before he commences to work on the books concerned. In checking balances, unless the same are brought down in ink, the auditor should require the amount of each balance to be noted at the side of the ledger account in ink, which preferably should be of some

other colour than that used in the body of the ledger. If this is not done, the auditor must himself note such balances in ink, in order to avoid the risk of items being inserted afterwards which would affect the balance.

It is not the business of an auditor to balance the books, and he must take care to relieve himself of any responsibility for errors in balancing. Frequently the auditor is requested to balance the accounts, but, if he undertakes this work, he does so in the capacity of accountant, and not of auditor, and it should be subject to a separate arrangement. The question often arises whether it is advisable for the auditor to commence the audit before the books are balanced. Sometimes it is found necessary to do so in order that the audit may be completed within the required period; but it is not desirable, since it increases very materially the risk of passing errors, as the books have not, in the first instance, been subjected to the clerical test obtainable by the Trial Balance.

Where necessary, the auditor should make clear to his client the exact nature of the responsibility assumed having regard to the nature of the work undertaken.

§ 6.—The Qualities required of an Auditor.

The general principles of auditing having been indicated, it may be profitable to point out the essential characteristics which an auditor must possess if he is to perform his duties efficiently.

In the first instance it is imperative that the auditor should have a wide knowledge of the theory and practice of book-keeping and accounts, and should be so familiar with the underlying principles thereof, that he can apply them without difficulty to

transactions of which he has had no previous experience. It is impossible for a person to audit an account properly unless he is capable of preparing that account himself. The lack of this fundamental requirement is the principal cause of inefficient auditing, and it cannot be too strongly insisted on, that the only safe rule to adopt is never to pass a transaction if its precise meaning is not understood. Unfortunately this principle is often transgressed by those who, not having the requisite experience or knowledge, are afraid to ask the necessary questions, and consequently pass the item blindly, trusting to luck that it is in order. Such a habit—for it is apt to become a habit—involves very heavy risks, and is certain to end sooner or later in disaster. It is impossible for everyone to have experience in every class of business, and occasions must from time to time arise when the auditor is presented with transactions of a technical nature, of which he has no knowledge.

The proper course for the auditor to pursue in such circumstances is to ask intelligent questions of his clients or their staff, and thus place himself in possession of the requisite information to enable him to criticise the transaction. The exercise of a certain amount of tact is required, and considerable caution is needed to avoid putting questions which, owing to ignorance of technicalities, would appear ridiculous; but, assuming this to be done, greater respect will be gained by an honest admission of unfamiliarity with the transaction, than by the assumption of knowledge which is not possessed, and the lack of which will be almost certainly discovered.

Lord Justice Lindley said: "An auditor must be honest—that is, he must not certify what he does not

believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true" (*In re London and General Bank* (*No.* 2), 1895, 2 Ch. 683).

If there is a difference of opinion between the auditor and his clients on a matter of importance, he must have the courage of his convictions. He must possess, in some considerable degree, that characteristic of genius—an infinite capacity for taking pains; he should possess tact and patience; he must be conscientious, and must not be hurried into signing a certificate or report until he has received the whole of the evidence which he requires, or sign under a promise that evidence required will be forthcoming the next day.

An auditor must exercise constant vigilance; he must not allow his work to become automatic, or to lapse into a mechanical routine. He must be accurate, since his function is to detect the mistakes of others; he must be methodical, in order that no detail of his work may be omitted; he must be cautious, but he need not be unduly suspicious. As Lord Justice Lopes said: "An auditor is not bound to be a detective or, as was said, to approach his work with suspicion, or with the foregone conclusion that there is something wrong" (*In re Kingston Cotton Mill Co.* (No. 2), 1896, 1 Ch. 331), and he must never relax his high standard.—"If an auditor has, even in one instance, fallen short of the strict duty of an auditor, he cannot, I apprehend, be excused merely because in general he has displayed the highest degree of care and skill" (per Romer, J., *In re The City Equitable Fire Insurance Co., Ltd.*, 1924, Acct. L.R. 53 and 81).

If asked to give his advice in matters of financial policy, or to suggest improvements in the accounts, an auditor must be prudent, and above all things practical. Theoretical knowledge can often be pushed to excessive extremes, and it must be tempered with a nice appreciation of practical possibilities.

Last, but not least, the auditor should have a full share of that most valuable commodity—common sense.

CHAPTER II

THE AUDIT OF CASH TRANSACTIONS

§ 1.—Internal Check as regards Cash.

Before commencing the audit of the cash transactions of a business, it is most important that the auditor should make himself familiar with the system of internal check in operation under this heading, since the majority of frauds arise directly in connection with cash.

A system of internal check is an arrangement whereby the work entailed in carrying out and recording transactions is so allocated and divided between various members of the staff that fraud can only be perpetrated by collusion between two or more persons, and that errors and irregularities shall be capable of immediate detection by the automatic operation of the system.

It is not intended to set out here any complete system of internal check as regards cash, but merely to indicate the main points to which an auditor should direct his attention.

The duties of the cashier must be ascertained, particularly as to whether he has charge of any ledgers or books of prime entry other than the Cash Book. In large businesses, the cashier will be fully employed with his proper duties, but in smaller concerns it is not usually found possible to occupy the whole of one man's time in the performance of the duties of a cashier. In such cases, the opportunities for the concealment of fraud by the cashier are considerably enlarged.

(a) Receipts.

The method of dealing with moneys received should be ascertained, and particular reference made to the following points :—

(1) Whose duty it is to open letters containing remittances.

(2) Whether all remittances are immediately crossed, by means of an indiarubber stamp, to the firm's bankers, and marked "Not Negotiable."

(3) Whether the remittances are entered in a rough Cash Book or Diary, and checked and initialled by at least two persons, neither of whom is the cashier; and whether the daily totals of such Diary are subsequently compared with the entries in the Cash Book, and if so, by whom.

(4) Whether printed counterfoil receipts are utilised, and if so, whose duty it is to make them out. This work should not be done by the cashier, or by anyone connected with entering the remittances into the Diary. Unused counterfoil receipt books should be kept in safe custody.

(5) Whose duty it is to enter up the counterfoil of the paying-in book. The cashier should enter up the slip to be retained by the bank, while the clerk who makes out the counterfoil receipts should enter up the counterfoil portion of the paying-in book.

(6) Whether all receipts are banked daily, and whether or not the clerk, whose duty it is to take moneys to the bank, is otherwise engaged in connection with the cash transactions.

(7) As to the method of recording and checking cash sales (if any).

(8) Whether there is any authority for travellers to collect debts, and under what conditions.

(9) As to the frequency with which the Pass Book is checked with the Cash Book, and Reconciliation Statements prepared, and whether this is performed by anyone in addition to the cashier.

(10) As to the custody and treatment of bills receivable.

(b) Payments.

The auditor's attention should be directed to the following points :—

(1) Whether all payments are made by cheque, with the exception of those dealt with through petty cash; who has authority to sign cheques, and whether any counter-signature is required.

(2) Whether cheques are "Bearer" or "Order," and whether they are crossed "A/c Payee only—Not Negotiable" before being sent out.

(3) Whether proper regulations are in force for the checking of statements with invoices before the cheque is drawn, and comparison of the same with the account in the Bought Ledger.

(4) Whether vouchers are properly numbered and filed in order. This work should not be performed by the cashier.

(5) What regulations are in force to sanction payments of a special nature. This authority should be exercised only by principals or directors.

(6) What system is in operation as regards petty cash.

(7) What system is in operation as regards the preparation and payment of wages.

§ 2.—Vouching Payments.

(a) General Considerations.

The auditor, on commencing to vouch the payments side of the Cash Book should ask for the cash vouchers, which should be in readiness for him, numbered and filed consecutively in order of entry in the Cash Book.

Where proper preparation is not made for the auditor, it is common to find the vouchers entirely out of order, and unnumbered. This indicates a lack of organisation, and the auditor is entitled to request that the vouchers be put in proper order before he commences to examine them, as otherwise he will find, if the payments are numerous, that a great deal of time will be required to find the voucher for each particular payment.

As soon as each voucher is passed, the auditor should cancel it, preferably by the use of a rubber audit stamp, in order to prevent the same voucher being produced on a subsequent occasion. All subsidiary documents, such as invoices, statements, etc., relating to the voucher, should also be cancelled.

In examining the vouchers, the auditor should pay attention to the following points :—

(1) The name of the party to whom the voucher is addressed.

(2) The date of invoice or statement and signature to the receipt, and whether such receipt is on the authorised form of the payee, where such form is utilised.

(3) Whether properly stamped.

(4) Nature of payment.

(5) Whether the payment has been passed as in order.

(6) The account to which the item is posted.

It is important for the auditor to observe the name of the party to whom the voucher is addressed. The fact of its being addressed directly to the business concerned is *primâ facie* evidence that the payment relates to the business, but in some cases it may be found that vouchers are addressed to an individual, such as a partner, director, or manager. When this is so, care must be taken to ascertain that the payment is a proper business one, and the auditor should make certain of this by referring to the original invoice to which the payment relates, and seeing that the goods are of such a kind as would be utilised by the business; also it might be advisable to refer to the Goods Received Book or the suppliers' advice notes, to see that the goods have actually been received by the business. If the item does not relate to goods, it is still more necessary for the auditor to make sure that it is actually connected with the business, and he will do this by examining whatever evidence is available. The habit of addressing statements and vouchers to individuals instead of to the business is an unsatisfactory one, and requests should be made to the parties responsible for it, to avoid doing so in future. If, however, there are any items properly chargeable to individuals, the auditor should ascertain that such payments are debited to the personal accounts concerned.

The date of the receipt should be noted to see that it corresponds with the actual entry in the Cash Book,

the year being specially observed, as instances have occurred where an old account, relating to a previous year, has been utilised as a fictitious voucher for a fraudulent payment in the current year. The signature should be examined, and where a notice is printed on the statement that only the firm's printed receipts will be recognised, it should be seen that such printed form has been used. The use of printed forms, or of a rubber stamp containing the name of the firm to whom the payment has been made, is material collateral evidence of the genuineness of the voucher. Where printed or stamped forms of receipt are not utilised, the signature should be examined, as such vouchers lend themselves more easily to manipulation. Where the amount of the sum received is not written, but entered in figures, such figures should be scrutinised, since the addition of a cipher might be very easily made. In all cases the figures of the receipt should be compared with the figures of the account.

Vouchers for amounts of £2 or over should bear a twopenny stamp, and the auditor should see that the stamp is affixed where necessary. There are certain cases, however, where the use of a receipt stamp is not compulsory, *e.g.*, on vouchers for salaries, Parliamentary taxes and duties, and for donations and subscriptions to charitable institutions where their funds are used exclusively for charitable purposes. Vouchers for payments made by one department to another, or for disbursements expended on behalf of the business, do not usually bear a stamp. Foreign vouchers will only bear the stamp of the country in which the receipt is signed, if such is legally necessary.

One of the principal objects of vouching is to ascertain, not only that money has been actually

paid away by the business, but that the payment has been made in respect of a transaction relative to the business, and that, as such, it is properly recorded. The nature of the payment, therefore, becomes a point of material importance. If the invoices relating to each statement are attached to the voucher, these should be cancelled by the auditor, and checked on to the statement, and he will thus be able to ascertain the nature of the goods to which they relate. As far as the operation of vouching the cash is concerned, this is the best method of filing invoices, but invoices are often filed separately, only the statements appearing on the file of vouchers. It is not then so easy to ascertain the nature of the payment, though the names of the parties, with whom the firm is accustomed to deal, will soon become familiar to the auditor. In doubtful cases, the original invoices should be turned up, and examined, and, as previously mentioned, it may sometimes be advisable to proceed still further and check the actual receipt of the goods by examining the Goods Received Book.

The auditor will have ascertained whether there is an efficient system of internal check as regards the examination and checking of invoices and statements for payment, and he should also ascertain the names of the parties whose duty it is to perform this work, and to initial the documents as having been checked. In examining the vouchers, therefore, it should be seen that the items have been properly checked and initialled by the parties responsible, and particular care should be taken, where the payment is of a special nature, to see that it is duly authorised.

As each item is vouched, the auditor should ascertain whether it is posted to a personal or an impersonal account. If to a personal account, the transaction

in respect of which the payment has been made, will have been originally recorded through some other book of prime entry, such as the Bought Day Book, and will be subject to the auditor's examination in connection with that book. Where, therefore, the original invoices are not filed with the vouchers, it is unnecessary to refer to them in connection with an item that is posted to a personal account. If, however, the item is posted to an impersonal account, the entry in the Cash Book will, in all probability, be the original entry relating to the matter, and the payment must be fully substantiated by all the documentary evidence available, since the correct account in the impersonal ledger, to which the item should be posted, will be determined by the nature of such evidence. In order to avoid the possibility of an item being paid twice over, either in error or fraudulently, by means of being passed first through the Bought Day Book (the cash payment in respect thereof being posted to the creditor's account), and also paid on an invoice, and posted direct to an impersonal account, the auditor should not accept any receipted invoice as a voucher without exercising due caution.

The custom of certain business houses to issue their own forms of receipt when making payments, though it may have considerable advantages from the point of view of uniformity, is disadvantageous to the auditor, inasmuch as it eliminates from the vouching the material evidence to be derived from a receipt on the printed account or form of the payee, and in such cases the auditor should require documentary evidence, in the shape of statements or invoices, to be attached to the formal receipts. Similar remarks apply to the system of utilising the indorsement of a cheque as a form of receipt, accompanied, as a rule, by a

notice that no other form of receipt is required. In such a case it will not be sufficient for the auditor to examine the returned cheques only, as no evidence of the nature of the payment will be afforded, in most cases, by the indorsement, but he should also require production of additional evidence as above-mentioned.

Discount allowed by trade creditors is usually entered in a special column on the credit side of the Cash Book reserved for discount, the entry being made opposite the payment to which it relates.

The auditor should see that discount is taken advantage of wherever possible.

The discount column should be cast, and the total checked to the credit of Discount Receivable Account in the Impersonal Ledger.

(b) Missing Vouchers.

As soon as the auditor has completed his examination of the vouchers, he should extract a list of items which remain unvouched.

Vouchers for certain items will not be found in the ordinary voucher file, but the payments can be verified by reference to other books and documents. These will be dealt with subsequently, but there may remain a certain number of payments for which vouchers are altogether missing. It may be possible to accept the indorsed cheque as sufficient evidence of payment. This course may be adopted where collateral evidence is available that the payment is in order, or where the payment is of a regular and certain amount, such as salaries, or directors' fees, and where the signature of the payee is well known to the auditor. It is not desirable, however, to rely upon indorsed cheques more than is absolutely

necessary, and as a rule, where vouchers are missing, duplicates should be obtained. The idea that indorsed cheques can be taken as effective vouchers in the absence of other evidence is unsound.

Sometimes specific receipts are not available for payments on account, but these items can usually be vouched by reference to the final statement on which credit is given therefor.

(c) Capital Expenditure.

The vouching of payments made on account of capital, and posted direct from the Cash Book to the asset account, is of great importance, since any erroneous treatment will directly affect the amount of profit or loss.

The subject of the distinction between capital and revenue expenditure demands separate treatment, and it is only proposed here to deal with the vouching of cash payments on capital account, and to indicate the procedure to be adopted in dealing with the usual classes of payments of this nature.

(1) *Freehold and Leasehold Property.*

As a rule, there will be no actual receipt for the purchase price, though evidence may be available in the shape of letters from solicitors, or others. The actual title deeds, and conveyance, or the lease, should be examined, and the purchase consideration ascertained. The law costs in connection with the acquisition of capital assets can be regarded as part of the cost thereof, and should be vouched by reference to the solicitor's account.

(2) *Buildings.*

Where the building is being erected under contract, the actual contract should be examined

and also the accounts for extras, if any. Payments under the contract will usually be made on an architect's certificate, and this should be seen by the auditor, in addition to the actual receipt given by the builder. The architect's fees should be vouched by reference to his account; such items form part of the cost of building and can be charged to capital. In certain cases, the buildings may be wholly or partially erected by the staff of the business, in which event allocation of materials and wages will be necessary. Such division will not, however, usually be made through the Cash Book, but will be dealt with through the Bought Day Book and Journal respectively; and the vouching of such allocation will consequently arise in connection with those books. In some instances, however, cash purchases may be debited direct to the asset account, and the auditor will then examine the invoices, in order to ascertain that the items are of a capital nature, and to see that they have been properly examined and passed by an authorized person.

(3) *Plant and Machinery.*

Similar considerations apply here as in the case of buildings, and all cash payments debited direct to the Plant Account will be examined in the same manner. Care must be taken to see that the expenditure is properly chargeable to capital.

(4) *Patents.*

The actual patent should be examined. If the patent has been purchased, the assignment should also be seen, together with the receipt for the purchase consideration. Patent agents' fees in connection with the acquisition can be charged to capital, and will be

vouched by production of the agent's account. Fees for renewal of patents must not be charged to the Patent Account, as they represent revenue expenditure.

(5) *Payments under Hire-Purchase and Instalment Agreements.*

The actual hire-purchase agreement, or agreement to pay by instalments, should be examined, and the vouchers seen for the payment of the instalments. As each instalment will include the proportion of interest which should be charged to revenue, care must be taken to see that the interest is not debited to the asset account, or, if this is done in the first instance, that it is afterwards transferred. In the case of wagons bought on the hire-purchase system, the amount of the interest is sometimes shown on the statements rendered by wagon companies. In other cases, the rate of interest should be ascertained, and adjustment made accordingly.

(6) *Investments.*

For the purchase of investments the brokers' bought note and receipt will be examined. The proper vouching of the item will also include the inspection of the securities; but this is not usually done in the course of vouching the Cash Book. It will be dealt with when the verification of assets is considered.

(7) *Loans.*

The receipt from the borrower should be inspected if the loan is without security. If on mortgage, the mortgage deed will state the amount of the loan,

and should be examined, together with the title deeds. It should be seen that there is proper authority for the loan.

(8) *Office Furniture, Fixtures and Fittings.*

Similar considerations apply as in the case of plant and machinery, and all cash payments debited direct to the Furniture Account will be examined in the same manner.

Where the fixtures form landlord's fixtures, this fact should be considered in providing the necessary amount of depreciation.

(d) Special Payments.

Certain payments found in most classes of businesses are subject to special considerations in vouching, and the more important of these are here noted. Special payments particularly relating to companies will be dealt with in Chapter VII.

(1) *Agents' and Travellers' Commission.*

The agreement should be examined to ascertain the actual basis on which the commission is to be calculated and arrangements as to expenses. The travellers' receipts for the commission paid should be seen, and the Commission Books examined and the calculations tested.

(2) *Travelling Expenses.*

Travellers' expenses, when payable by the business, are frequently arranged on some fixed basis, and when this is the case, it should be seen that such is not exceeded. In other cases, the voucher for travelling expenses should specify the details of the expenditure

where the amount involved is of any consequence. Where no details are afforded, the auditor should ascertain that the amount has been passed as in order by a responsible official.

(3) *Insurance Premiums.*

The insurance company's receipts will be in evidence for such payments. In the case of first premiums, where interim receipts have not been issued, the auditor will examine the policies, which will contain a note of the premium paid.

(4) *Bank Charges.*

Bank charges for commission, cheque books, interest on overdrafts and loans, etc., should be vouched by inspection of the Pass Book, and where necessary the calculations should be checked.

(5) *Salaries.*

A Salaries Book should be in use, containing particulars of weekly and monthly salaries. This should be cast by the auditor, and cheques drawn for salaries vouched therewith. If it is customary to obtain receipts, these should be examined. Any changes in the salary list should be verified. Wages are dealt with separately in § 3.

(6) *Petty Cash.*

Cheques drawn on account of petty cash should be vouched by ascertaining that they are properly entered on the receipts side of the Petty Cash Book, care being taken to see that the dates correspond. The vouching of the Petty Cash Book itself is dealt with in § 7.

(7) *Bills Payable.*

The returned bills, duly cancelled, will be in evidence as vouchers.

(8) *Bills Receivable Dishonoured.*

If a bill receivable has been discounted through the bank, but is dishonoured on presentation, the amount of the bill will appear as a payment in the Pass Book, and will also be entered in the Cash Book, being posted therefrom to the debit of the person from whom the bill was received.

Where the bill has not been discounted, but has been deposited with the bank for collection, it is common to find the amount thereof credited by the bank on the date it becomes due, being subsequently debited if the bill is dishonoured.

The auditor should examine the dishonoured bill, if it has not been since met or retired. The expenses of noting will appear in the Pass Book (in cases where the bill has been presented through the bank), and should be debited to the person from whom the bill was received.

The expenses of discounting a bill will be vouched with the Pass Book, if the bill has been discounted with the bank, and should be charged to the Discount Account. In vouching the charge for discount it should be remembered that it is based on the nominal amount of the bill, and not on the money advanced by the bank. Thus the real interest charged is at a higher rate than would appear from the discount quotation.

(9) *Freight and Carriage.*

Freight and Carriage Accounts require careful examination. Where the accounts are voluminous, payments are sometimes made on account throughout the month, and a final statement rendered. Such statement should be checked with the Carriage

Accounts, and the payments on account vouched thereto, thus ensuring that all such payments have been brought into account.

In railway accounts a rebate is often allowed for cartage, where the rates charged include cartage, but such cartage is performed by the customer or his agent. The receipt given by the railway will be for the full amount, and a contra receipt is given by the customer for the rebate. The auditor should ascertain whether such rebates have been allowed, and see that the actual cash payment made corresponds with the net amount payable. Rebates are also afforded by shipping companies in some cases.

(10) *Customs Duties.*

Where Customs duties are paid by a railway or forwarding agent on behalf of a customer, they will render monthly accounts, and issue receipts for payments on account, which should be examined by the auditor. Where the transactions are numerous, such accounts will follow the same principle as the Freight Accounts above mentioned.

Where duty is paid direct in cash, receipts are not always issued, but an acknowledgment can be obtained from the Customs House on the occasion of each payment, if it is asked for. Where these have not been obtained, the auditor should request that they should be arranged for.

Payment is made in cash or by a transfer on the Bank of England. The latter is the usual mode for payment of large sums, and the auditor will then see no voucher except the returned transfer, which is, in effect, a cheque payable. It is important, therefore, that the auditor should see that there is a proper system of internal check upon the amount paid for duty.

In special cases, the Customs authorities will accept a guarantee cheque, in which case they will issue receipts for the payments made.

As the sums involved are sometimes very large, and special opportunities exist for fraud in connection therewith, the auditor should vouch the Duty Account thoroughly.

In the case of Purchase Tax and Entertainments Tax, Customs receipts are issued, and the payments should be verified therewith.

(11) *Income Tax and Profits Tax.*

In regard to the clients' own liability to these taxes, the official receipts should be compared with the relevant demands, and the entries in the Cash Book vouched therewith.

Income Tax deducted from employees' remuneration under "Pay-as-you-earn" must be remitted to the collector of taxes monthly, and the official receipts should be seen. The auditor should also check the amount of each remittance with the total of the deductions during the month in question.

(12) *Partners' Drawings.*

It is not usual for specific vouchers to be available in respect of partners' drawings, but where the payment is in the form of a cheque payable to the partner concerned, the returned cheques should be obtained, and the partner's signature examined. Where payments are made to third persons on behalf of partners, it is not always possible to obtain the receipts, and such items should be vouched by direct reference to the partner concerned. Where partners' drawings are numerous, each partner should be asked to initial his Drawing Account as being correct.

§ 3.—Wages.

(a) Internal Check as regards Wages.

The vouching of wages is a very important part of the auditor's duties in the case of a concern employing labour to any extent, since fraud has been found to arise more easily in this connection than in any other. It may be said that no auditor can satisfactorily vouch this item unless there is a proper system in force as regards the preparation of the wages sheets and the payment of the men.. The first care of the auditor, therefore, will be to examine the methods adopted, and if he then finds that the internal check in this connection is inadequate, he should immediately advise his clients of the risks likely to result from the continuation of such a system, and suggest to them what alterations he considers to be advisable. Should his recommendations not be adopted, he will be wise to disclaim any responsibility for errors or fraud in this connection, in order to protect himself from any subsequent charge of negligence.

The best system to be adopted in any particular case will naturally vary with the circumstances, but the principal dangers which any system should be designed to counteract are as follows :—

(1) Inadequate time records, whereby men may be enabled to receive pay for time not devoted to the business, or for time wasted in the works.

(2) Inadequate piece-work records, enabling pay to be received for work not executed.

(3) Errors in the preparation of the wages sheets.

(4) Fraudulent manipulation of the wages sheets, enabling moneys to be drawn in excess of amounts due, or fictitious names to be inserted.

In order to counteract these dangers, a system should be in operation which will afford the best check possible, and necessitate collusion between two or more officials before any fraud can remain undetected for any length of time. It is essential that any such system should be strictly adhered to, and supervised by those responsible for the control of the business, who should at all times be prepared to introduce such variation as experience proves to be advisable.

The following is an outline of a system of preparing wages sheets and paying the wages, which, if properly carried out, should effectually minimise the risk of fraud.

(1) *Time Records.*

The times of workpeople entering or leaving the works should be recorded, either by a gatekeeper or time-recording clock. In order to avoid loitering in the works, and to act as a check on the original record, the foreman of each department should take the times of the workpeople entering and leaving the shops, or time clocks should be utilised.

(2) *Piece-work Records.*

Where the pay is based on the actual work performed, and not on the time occupied, an efficient system of recording piece-work is essential. When the work is given out it should be entered on the piece-worker's card. On completion, this card should be initialled by the piece-work viewer as soon as the work has been examined and checked by him, and where possible, also by the stock-keeper.

(3) *The Preparation of Wages Sheets.*

Separate wages sheets or books should be utilised for time-workers and piece-workers respectively, and

should be ruled to record all the essential particulars, special columns being provided for the gross amount payable, deductions for Health and Unemployment Insurance contributions, Income Tax, holiday and sports funds, fines, etc., payments on account, and the net amount payable. Columns should also be provided showing the employer's contributions under the Insurance Acts.

The gate records and foreman's records as regards time should be compared by two clerks in the wages office, and any discrepancies enquired into. Another clerk should enter upon the wages sheets the names of the men employed, rates of pay, number of hours worked by each man daily, and particulars of any deductions. A separate clerk should work out and enter up the net amount due to each man, and cast the sheets, the calculations being checked by another clerk. Similar work should be performed in connection with the piece-workers' wages. Each man responsible for the preparation of the sheets should initial for that portion of the work performed by him, and the whole should be countersigned as correct by the works manager, a partner, or a director.

(4) *Payment of Wages.*

Wages should be paid by the cashier, who should not perform any part of the work detailed above. He should prepare an analysis of the wage payments, so that the proper amount of change can be obtained from the bank. A separate cheque should then be drawn for the precise amount of the wages, and each man's wages placed in an envelope endorsed with details showing the make-up of the contents. The men should attend personally to receive their wages, the foreman of each department being present when the

men in his shop are being paid, in order to avoid the possibility of substitution. Special arrangements should be made for the payment of wages of men who are absent, and the wages of one workman should not be paid on his behalf to another.

As a general rule it is not found possible to obtain the signature of each man for his wages, and where such a system as the above is in force, it is not necessary to do so. The payment should be attested by the signatures of the cashier and the foreman, and of the works manager, if present.

The occasional attendance of a partner or director whilst the workers are being paid also adds considerably to the check imposed.

(b) The Auditor's Duty as regards Wages.

The auditor will ascertain the precise particulars of the methods employed in preparing and paying wages, and will pay special attention to any portion of the system which he considers to be weak. Where such a system as the one described above is in force, the auditor will ascertain that it is regularly and properly carried out, and that the signatures and initials of those responsible are duly appended to the wages sheets. He will vouch the cheque drawn for wages with the total shown by the sheets, and check the casts and extensions of a certain proportion. The National Insurance Cards and Income Tax Deduction Cards should be called for and extensively tested with the names and particulars appearing in the wages sheets. This precaution should minimise the possibility of fraud by the inclusion of "dummy" names in the wages sheets. Sometimes it is arranged for the auditor to attend personally without notice at the time of payment of wages, though this cannot be considered part of his duties in the ordinary course.

§ 4.—Vouching Receipts.

(a) General Considerations.

From the auditor's point of view the operation of vouching receipts is more difficult than that of vouching payments, since only indirect evidence can as a rule be obtained.

The system of internal check should be carefully enquired into by the auditor, and he should direct special attention to any part that he considers inadequate. In order to ascertain that the system is properly carried out, he should test each portion of the check in operation, and if discrepancies are found he should carry his examination further. If, on the other hand, the transactions he has examined are in order, he is entitled to assume that the remainder can be safely passed. Where a rough Cash Book or Cash Diary is kept, such books should be tested exhaustively with the Cash Book proper, since, if amounts received are entered in the former but appropriated by the cashier, and not entered in the Cash Book, the auditor might be held responsible if he failed to detect the fraud, owing to his omission to examine the records available. This point is one of some importance, as it raises the question as to how far it is the duty of the auditor to go behind the financial books of the business, and to examine the memoranda books, if such exist, on which the entries in the financial books are based. There can be no doubt that where such memoranda books are part of the recognised system in force in the business, an auditor would be held negligent if he failed to examine them. This point emphasises the desirability of the auditor obtaining a list of the books in use, since, if such memoranda books are not included, he could not reasonably be

held to be cognisant of their existence as part of the financial system.

It is also essential that the auditor should test exhaustively the counterfoils of the paying-in book with the debit side of the Cash Book, noting particularly that the separate items making up the total lodgment are the same in both cases.

(b) Credit Sales.

Apart from checking the Sales Ledgers, the auditor cannot specifically verify receipts on account of credit sales, particularly where it is not the custom of the business to issue printed counterfoil receipts to its customers. Where counterfoil receipts are in use, the auditor should ascertain the regulations in force regarding them, and vouch a certain number of the counterfoils with the Cash Book.

It cannot be contended that in a large business it is the duty of the auditor to check the whole of the counterfoil receipts, since, in itself, this operation will not necessarily discover any frauds that may have taken place. There is nothing to prevent the amount of the receipt being entered on the counterfoil as less than the sum actually received. Further, unless unused counterfoil receipt books are kept in safe custody, there is nothing to prevent receipts being issued from unused books. On the other hand, if the counterfoil is properly filled in, but the entry in the Cash Book is incorrect, and the auditor fails to discover the fraud by omitting to check the counterfoil receipts, he might find himself in a position of some difficulty. All spoilt receipts should be attached to the counterfoils, and cancelled by the auditor, as far as his examination extends. It should be seen that the dates on the counterfoils correspond with those in the Cash Book.

Where travellers are authorised to collect moneys from customers, the regulations in force should be ascertained, and it should be seen that they are sound and regularly adhered to. If the travellers issue counterfoil receipts, the counterfoils should be tested. The travellers' returns, giving particulars of the amounts received, should also be examined and compared with the actual receipts in the Cash Book.

Discount allowed to debtors is usually entered in a special column on the debit side of the Cash Book reserved for discount, the entry being made opposite the receipt to which it relates. The auditor should ascertain the terms on which discount is allowed, and test a certain number of the entries to ascertain whether the discount is in order. This is important, as defalcations in respect of receipts have been concealed by means of fictitious entries of discount. The discount columns should be cast, and the total checked to the debit of the Discount Payable Account in the Impersonal Ledger.

(c) Cash Sales.

The opportunities for fraud in this connection are very numerous, and no amount of checking by the auditor will be of much avail unless an efficient system of internal check is in operation.

Assuming a proper system to be in force, the auditor will test exhaustively its operation by checking the counterfoils of the Cash Sales Books with the salesmen's summaries or abstracts. Each salesman's abstract should agree with the analysis of the cash received by the receiving cashier, the details of which can again be checked with the cash sales counterfoils. The daily totals of the receiving cashiers' Cash Books should be vouched into the General Cash Book.

Where automatic cash registers are employed, the daily totals entered in the Cash Book should be checked with the till rolls.

(d) Special Receipts.

Certain receipts of common occurrence are subject to special considerations in vouching, and the more important of these are here noted. Special receipts particularly relating to companies will be dealt with in Chapter VII.

(1) *Income from Investments.*

A separate Ledger Account should be utilised for each investment, and where a large number of investments is held, an Investment Ledger will usually be found. At the head of each account the full title of the investment should be stated, together with a note of the dates on which interest or dividends fall due. The auditor should ascertain that all dividends and interest that should have been received have been received at the proper dates. Where the rate is fixed, the amount of the dividend or interest can be verified by checking the calculation on the nominal value of the stock held. In other cases, the counterfoils of the dividend warrants should be seen. Where investments are sold *ex div.*, it should be seen that the dividends are subsequently received, and similarly when the purchase is made *cum div.*

(2) *Rents Receivable.*

In order to vouch the income derived from this source, the auditor should inspect counterparts of leases and agreements, noting the rent payable, and the provision as to repairs and allowances. He should then ascertain that all rents that should have been

received have been received, and vouch deductions made by the tenants. Inquiry should be made into arrears outstanding for any length of time, in order to ascertain whether they are genuine. Similar precautions must be taken in respect of properties which are shown as unlet. Where counterfoil Rent Receipt Books are utilised, the counterfoils should be checked. When rents are collected by agents, their accounts should be examined and vouched.

(3) *Interest on Loans and Bank Deposits.*

If the loan is secured by a mortgage, the deed will be consulted for the rate of interest and dates when payable. If the loan is unsecured, whatever other evidence is available will be inspected, and it should be seen that the interest is duly received. Interest on deposit will be verified by reference to the Bank Pass Book, and the correctness of the amount there credited can be tested by checking the calculations in accordance with the terms allowed by the bank. Where the deposit is a fixed yearly one, Income Tax will be deducted by the bank in crediting interest, otherwise interest will be credited gross.

(4) *Bad Debt Dividends.*

These items should be vouched by examining the counterfoils of the dividend warrants or other documents which will state the amount of the debt and the rate of the dividend.

(5) *Sales of Investments.*

The amounts received should be vouched by reference to the brokers' sold notes.

(6) *Bills Receivable.*

The Bills Receivable Book will be examined to ascertain the due dates of the various bills. The

proceeds of those discounted will be received prior to maturity, and should be vouched by reference to the Bills Book, or Bills Discounted Book, and the rate of discount charged. Those held till maturity should be received in full on the due date. If not so received, they will either have been retired and a new bill given, or dishonoured.

(7) *Miscellaneous Receipts.*

Other special receipts, such as receipts from the sale of fixed assets, receipts from insurance companies in respect of claims, etc., will be vouched by reference to the correspondence, and any other documents relating to the matter.

§ 5.—The Pass Book.

(a) Payments into Bank.

The desirability of paying all receipts into the bank daily has already been indicated, and where this regulation is in force, and a separate bank column provided on the receipts side of the Cash Book, the auditor should check the amounts paid in as shown by the Pass Book with the entries in such column. Note should be taken of the dates, to see that they correspond. The comparison of dates is important, since cases have been known where the cashier has continuously delayed the payment in of moneys for a few days, thus being in a position to manipulate regularly the current receipts.

Where no separate column is provided for bank transactions, the agreement of the receipts side of the Pass Book with the Cash Book may occasion considerable difficulty, and the auditor may be obliged to have recourse to the counterfoil Paying-in Book,

in order to ascertain how the items credited by the bank are made up. He will also examine this book in other cases where disagreement exists between the Cash Book and the Pass Book, and he should particularly refer to it for the purpose of vouching moneys received and paid into the bank prior to the date of closing the accounts, but not credited by the bank till the next period. As the Paying-in Book will show the actual date on which the items were paid in, and will be initialled by the receiving clerk, the record will be sufficient evidence that the moneys were paid in prior to the date of closing the accounts, if supplemented by an examination of the Pass Book for the subsequent period, to see that the moneys have been actually credited in due course. In certain businesses it is the custom to enter moneys received after the close of the balancing period, as if they had been received and paid into the bank on the last day of the period, in order that these transactions may be recorded in the books before the close of the period, and so reduce the outstanding balances. Such treatment cannot be regarded as in order, since it will have the effect of increasing the cash appearing in the Balance Sheet, and decreasing the outstanding debtors correspondingly. In this way the accuracy of the Balance Sheet is affected, but this can be remedied by decreasing the cash to the extent of the items in question, and increasing the debtors correspondingly. As, however, the Trial Balance of the books will include these items as having been received, the auditor must vouch the receipt thereof as if they had actually been received during the period and make the necessary adjustment on the final amounts.

The vouching of the totals paid into the bank with the entries in the bank column will not, of itself,

prove the correctness of those totals, and this should be done by casting the detail columns.

(b) Payments out of Bank.

Where the Pass Book has not already been agreed with the Cash Book, it will be necessary for the auditor to check the payments in detail with the Bank Pass Book, and he should be careful to observe that all bank charges, dishonoured bills, returned cheques, etc., have been properly recorded in the Cash Book.

Where, however, the payments are numerous, and a reconciliation statement has been prepared and presented to the auditor, it may not be necessary for him to check the payments with the Pass Book in detail, assuming those payments to have been vouched and the credit side of the Cash Book to have been cast. The Pass Book should, however, be checked in detail with the Cash Book for a representative period. Contras appearing in the Pass Book but omitted from the Cash Book, must be examined carefully, and their nature ascertained, particular attention being paid to the dates of the entries. Cases have arisen where frauds have been concealed by the manipulation of contras of this nature. They are occasionally due to errors on the part of the bank, rectified by contra entry, or more often to cheques paid in and returned on account of irregular indorsement, etc. The latter are not usually put through the Cash Book as returned, and the contra entry in relation to them will therefore not appear in that book. Similarly, great care must be taken to ensure that contras appearing in the Cash Book, but not in the Pass Book, are in order. Fictitious contras have often been made to cover up defalcations.

Cheques drawn before the close of the period, and appearing as payments in the Cash Book, but debited in the Pass Book in the succeeding period, should be checked through into that period by the auditor as far as possible. Where the method of treating as receipts items received in the succeeding period is adopted, as referred to above, it will usually be found that the same principle is applied as regards payments, with the result that the cash balance is reduced, and the creditors decreased correspondingly. In this case, a similar adjustment should be made to that described as regards receipts, in order that the Balance Sheet may be correct. For the purpose of reconciling the Cash Book balance with the Pass Book balance, however, such items must be regarded as outstanding cheques.

(c) Reconciliation with Cash Book.

A reconciliation statement should be prepared and submitted to the auditor, showing how the Cash Book and Pass Book balances are agreed, and the auditor should check the details thereof with the Pass Book. If no such statement is submitted, he will be obliged to prepare one himself, which he will do by taking the balance as shown by the Pass Book, adding thereto cheques paid in but not yet credited by the bank, and deducting therefrom outstanding cheques drawn but not yet presented for payment.

In large concerns separate Cash Books are often utilised for cash receipts and cash payments respectively. If this is done, the auditor should check the totals therefrom to the General Cash Book in which the balancing is effected, or to a Total Cash Account in the impersonal or private ledger, which is sometimes employed in order to prevent the staff from knowing the bank balance.

Difficulty is frequently experienced where there is a large number of cheques drawn for a similar amount, some of which are outstanding, and, in such cases, care should be taken to ascertain that those treated as outstanding according to the Cash Book are the actual cheques which were outstanding. Accuracy in this direction can be most conveniently assured by comparing the date stamped on the returned cheque with the date of the entry in the Pass Book, and this can be very quickly done where the numbers of the cheques are inserted both in the Cash Book and in the Pass Book.

The reconciliation of the Pass Book with the Cash Book, where there is an overdraft, follows on the same lines, but the cheques not credited will be deducted from the overdraft, and the cheques not cleared added thereto.

Where a reconciliation statement is prepared without the whole of the entries in the Pass Book and Cash Book being checked, it often happens that bank charges have been omitted, and consequently the reconciliation statement disagrees to that extent. This particularly arises where it is the custom of the bank to credit Scotch and Irish cheques less the commission charged, instead of crediting the full amount of the cheque and charging the commission on the other side.

Similar considerations apply when bills receivable have been discounted, and the bank has credited the amount advanced on the bill in place of crediting the full amount of the bill, and charging the discount on the other side.

§ 6.—Verification of Cash in Hand and at Bank.

Where all receipts are not banked, and all payments are not made by cheque, the balance appearing on

the Cash Book will be composed of cash in hand and at the bank, and will be divided accordingly, if separate columns have been utilised for cash and bank transactions, as should always be done.

In such an event, it is sometimes arranged that the cash balance in hand at the close of the period should be paid into the bank on that day, and where this is done, the auditor will be able to vouch the asset through the Pass Book. Where this procedure is not adopted, the auditor should, if possible, attend on the day of closing the accounts, and verify the balance in hand by actual inspection. This, however, is not usually convenient, and the auditor must then check the Cash Book up to the date of his attendance, and verify the existence of the balance in hand as at that date.

The inspection of the Pass Book is not sufficient evidence for the verification of the bank balance, since cases have been known where a fictitious Pass Book has been presented to the auditor, containing an apparently correct balance, when, as a matter of fact, the real Pass Book, not produced, showed a very much smaller amount. In one case, very large frauds remained undiscovered by the auditor because he omitted to call for further evidence of the balance. It is therefore essential that the balance as shown in the Pass Book should be verified, either by a certificate from the bank, or by actual inspection of the banker's ledger. It is more usual for the former method to be adopted, and it is advisable that this certificate should be sent direct to the auditor.

Cash on deposit should be verified in a similar manner, and if deposit receipts have been issued these should be examined.

§ 7.—Petty Cash.

(a) General Considerations.

The treatment of petty cash payments is often regarded as an unimportant matter, and it is common to find in the case of businesses which have not been subject to audit, that the petty cash arrangements are very inadequate, and afford numerous opportunities for manipulation. Under these circumstances it is not unusual to find that fraud has taken place, and it is therefore essential for the auditor to direct his attention to this subject, and recommend the adoption of a proper system. This is the more important, as vouchers cannot be obtained for a large number of petty cash payments. Moreover, in most businesses of any size, the payments, though small in individual amount, are very numerous, and it will not be possible for the auditor to satisfy himself, by the usual method of vouching, that all the payments are in order.

Cheques drawn for petty cash are often posted to a Petty Cash Account in the Impersonal Ledger, and the details of the petty cash itself recorded in a small rough Cash Book. In such cases, the auditor will usually find on inquiry that there are no vouchers worth speaking of to support the payments, and the book is not subject to the examination of anyone other than the petty cashier. The expenditure made will probably not be analysed, but the total, debited to the Petty Cash Account in the Impersonal Ledger, will be written off to Profit and Loss Account.

Such a system should be discouraged by the auditor, and he should recommend the adoption of a columnar Petty Cash Book, containing on the debit side a column for receipts, and on the credit a column

for total payments, with subsidiary columns for the various classes of expenditure usually incurred. Each item of expenditure should be extended into its appropriate column, and the book balanced at least once a month. A column should be provided for the voucher number, and the vouchers numbered and filed in order. It is advisable to provide an additional column, into which to extend items for which there is no specific subsidiary column. A folio column will be provided, and each item posted to the debit of the account to which it relates.

There are two methods of regulating payments to the petty cashier, the first being to draw cheques as and when required for petty cash purposes, these being entered in the receipts column of the Petty Cash Book.

The second method is known as the *imprest system*, under which the petty cashier receives a starting sum, the amount of which will be determined by the normal demand on the petty cash. When the balance requires replenishing, a cheque is drawn for the precise amount of the petty cash payments, thus placing the petty cashier in possession of his original balance. This system has certain advantages in some cases, since it necessitates the Petty Cash Book being kept regularly written up, as the petty cashier should be required to furnish an analysis of the payments made each time that he requires a further cheque. It is particularly applicable where the petty cash relates to a branch, or when it is inconvenient to draw petty cash cheques at short notice. In other cases, it might be disadvantageous, since it might result in placing a larger balance in the hands of the petty cashier at the commencement

of each period than is necessary. On the other hand, the imprest system is convenient for checking purposes, since at any moment the cash in the hands of the petty cashier, plus any vouchers for payments made since his balance was last replenished, should be equivalent to his original opening balance.

(b) Internal Check as regards Petty Cash.

It has been pointed out that it is not usually possible for the auditor to verify the petty cash transactions in detail, and therefore it is advisable that, in addition to a good system of account, there should exist an efficient internal check, by means of which the petty cash can be kept effectively under control.

The points to which such a system should be applied are as follows :—

(1) The petty cashier should be a responsible official, but should not himself be the cashier.

(2) The only receipts paid into petty cash should be cheques drawn for that purpose. Sundry cash receipts are often entered in the Petty Cash Book, but this is inadvisable, and the rule should be enforced that all receipts, however small, should pass through the cashier's hands, and be paid into the bank.

(3) No payment should be made unless a proper voucher is obtained. Many payments are, however, of such a nature that no receipt is available, and to enable a proper record thereof to be obtained, petty cash slips or dockets should be provided, and the person making the payment should be required to insert the necessary particulars, and initial for the sum received, the docket being

counter-initialled by a responsible official where necessary. In this way either an actual receipt or a docket will be in evidence for each payment.

(4) At frequent intervals the Petty Cash Book should be checked in detail with the vouchers, and the balance in hand verified by some responsible official, who should initial the Petty Cash Book accordingly.

(5) No clerk should be allowed to borrow from the petty cash under any circumstances.

(c) The Auditor's Duty in relation to Petty Cash.

Where a good system of petty cash, supported by an efficient internal check, is in force, the auditor will not, as a rule, find it necessary to perform much detail work. He should ascertain that the system is regularly carried out, vouch the cheques drawn for petty cash from the credit side of the Cash Book to the debit side of the Petty Cash Book, and cast the receipts and total payments columns of the latter. The totals of the subsidiary columns should be cross-cast, and agreed with the total payments.

The vouchers should be tested exhaustively, either by taking a certain consecutive period, or by examining all vouchers over a certain amount. If, in the course of this investigation, irregularities are brought to light, the auditor should pursue his examination further.

Occasional attention should be directed to the Postage Book, and the amounts paid out of petty cash for postage checked with such book. It should be seen that the Postage Book has been regularly

checked, and it may be advisable to count the balance of stamps in hand where this is considerable. The main point, however, is for the auditor to see that a proper system of check on the postage is in force, since otherwise the opportunities to commit fraud may prove too tempting to be resisted. Frauds in connection with postage, although they may individually relate to small amounts, are sometimes consistently practised for a long period, and may in this way ultimately involve a considerable sum. In small points of this nature business men are frequently negligent, and when the auditor draws attention to the weakness of the system employed, are sometimes apt to dismiss the subject as too small for notice. It cannot, however, be too strongly emphasised that it is the duty of all employers to safeguard their employés against temptation to commit fraud, by utilising proper systems of check; and frauds on postage or petty cash, though they may involve comparatively small amounts, have as great an effect in undermining the character of the person concerned as those of a larger nature. It should be remembered also that the persons employed to conduct these transactions are usually not in very remunerative positions, and consequently the attraction of an extra few shillings a week may prove of material moment to them.

Where the Petty Cash Book is kept on the columnar principle, it may be made to form part of the double entry, and, in that event, there will be no Petty Cash Account in the Impersonal Ledger, and the balance of the Petty Cash Book will form part of the Trial Balance. The totals of the columns will, in such a case, be posted direct from the Petty Cash Book to the Impersonal Ledger, and should be checked

by the auditor. Otherwise a Petty Cash Account will be opened in the Impersonal Ledger, which will be debited with all cheques drawn for petty cash, and credited with the analysis of the various payments, either through the Journal, or by way of direct transfer to the ledger accounts involved. The auditor should vouch such transfers with the analysis of the petty cash, and see that the balance brought down on the Petty Cash Account in the Impersonal Ledger agrees with the balance as shown on the Petty Cash Book.

Where the petty cash system is not a good one, and where there is no effective internal check, the auditor should examine the transactions carefully, and vouch them as far as possible. Where the evidence of payment is not sufficient, he must report to his clients the facts of the case, and inform them that he cannot hold himself responsible for the accuracy of petty cash transactions, owing to the lack of available evidence.

In any event, the auditor should verify by actual inspection the balance in hand. Where possible this should be done without previous warning and not confined to the day of the Balance Sheet. The Petty Cash Book must be vouched up-to-date and the petty cashier called upon to produce his cash balance. It will frequently be found that such balance consists in part of IOU's. Due note should be taken of these by the auditor, and he should report the matter to his clients.

Where two or more Petty Cash Accounts exist, the balances should be verified simultaneously, in order to avoid substitution of one balance for another.

In the case of the *London Oil Storage Co., Ltd.* v. *Seear, Hasluck & Co.* (Acct. L.R. 30, p. 93), it was found that the auditors had committed a breach of duty in not vouching the existence of the petty cash balance, which was shown by the books to be £796, but was in fact only £30. The mere size of the alleged balance should have aroused the auditor's suspicions.

CHAPTER III

THE AUDIT OF TRADING TRANSACTIONS

§ 1.—Purchases.

(a) Internal Check as regards Purchases.

It is highly important that a proper system should be in force for the purpose of checking the receipt of goods and the accuracy of invoices, in order to prevent fraud and errors, and to ensure that the business only pays for the goods which it actually receives.

Before entering on an examination of the purchases the auditor should ascertain what system, if any, is in force, and the following are the principal points to which his attention should be directed :—

(1) Which officials are authorized to sanction the ordering of goods ?

(2) Whether a Goods Inwards Book is kept by the gate-keeper, in which particulars of all goods received are entered.

(3) Whether the invoices, when received, are checked by the invoice clerk with the Order Book, and the number of the order entered upon them. The invoices should also be checked with the Goods Inwards Book, to ascertain whether the goods have been actually received, and a reference made both in the Goods Inwards Book and on the invoices. This should prevent the entering of fictitious invoices or the treatment of duplicates as originals. The invoice clerk should initial each invoice, to indicate that he

has checked the calculations and verified the items as above described.

(4) Whether each invoice is then passed to the particular department from which the goods were ordered, the manager of which should initial the same, thus making himself responsible for the correctness of the price and quality of the goods.

(b) The Bought Day Book.

Various forms of Bought Day Book are utilised, but the columnar system is now very generally employed, under which separate columns are provided for each class of expenditure or for departmental analysis. Such a book should contain columns for the number of the invoice, the date, the name of the creditor, and particulars, Bought Ledger folio, total column, and subsidiary columns, headed according to the nature of the business and to the subdivision required. It may be found convenient to provide a further column, entitled a ledger column, in which can be inserted all those items for which no subsidiary column is provided, the same being posted separately to the particular ledger accounts to which they refer.

The amount of each invoice will be entered, and the invoices numbered consecutively. Where the system of internal check is adequate, it will be sufficient for the auditor to test the casts and cross-cast of the subsidiary columns to see that they agree with the grand total. The postings of the totals of the subsidiary columns will be checked to the accounts in the Impersonal Ledger to which they relate.

Examination of invoices and any other original documents should be made as exhaustive as possible (*see p.* 76).

Where the columnar form is not utilised, but a single column Day Book is employed, it will probably be necessary for the items to be analysed, monthly, or at other intervals, according to the various nominal accounts to which they relate, and the auditor should see that this is correctly done. The columnar system, however, has such considerable advantages over the older form, that its adoption should be recommended by the auditor wherever possible.

In some cases the number of columns required is too large to enable them to be conveniently dealt with in one book, and the Bought Day Book should then be divided into two or more sections. In such cases it is usual to find an Expenses Day Book in operation, recording all invoices relating to expenses other than purchases of goods.

(c) Vouching Invoices.

The auditor should see that the invoices are initialled by the clerk whose business it is to check them. Each invoice relating to goods should bear a reference to any Goods Inwards Book, and the auditor should occasionally refer to any such book to see that the goods stated in the invoice have actually been received. Care should be taken to see that the invoices are made out in the name of the firm, and appear to be of a nature relating to the business carried on. It should be seen that each item is extended into its proper subsidiary column, and if any column is provided for capital expenditure, such as plant and machinery, the items contained therein should be checked, and it should be ascertained that they are strictly of a capital nature. All such items should be passed and initialled by some senior official.

In some businesses it is the practice to allow the directors or members of the staff to order goods for themselves and to obtain the benefit of trade discounts. Unless special care is exercised in relation to such goods there is the possibility that they are not correctly charged out to the recipients, and the auditor should take care to see that each such invoice has a corresponding sales invoice.

At the close of the balancing period it is important for the auditor to ascertain, as far as possible, whether all goods received prior to the date of closing the books are included in the purchases, since, if they are included in the stock but omitted from the purchases, the profit will be over-stated to that extent. A common method of inflating the profits is to manipulate the purchases in this manner, and where no proper system for dealing with the receipt of goods is in force, it may be difficult for the auditor to detect fraud or errors of this nature.

Where, however, the Goods Inwards Book is duly referenced to the invoices and Bought Day Book, it can be ascertained whether goods received prior to the date of closing the accounts are brought into the Day Book before that date or not. If they are entered in the succeeding period, the auditor must ascertain whether they have been included in the stock, and whether they were actually received before the date of closing the accounts or not. If so received, they should be included in the stock and in the purchases.

In the absence of a Goods Inwards Book, it may be necessary for the auditor to refer to the suppliers' advice notes received with the goods. It frequently occurs that such advice notes are used as the basis of

the warehouse stock records and will be available to the auditor for reference.

Errors sometimes arise in this connection owing to the system prevalent in certain trades of post-dating invoices. This system is adopted for the purpose of giving a fictitious credit—all goods ordered, say, after the 20th of each month being post-dated to the 1st of the following month, in order to extend the term of the two or three months' credit that may be allowed. For the convenience of the ledger keeper, it is usual to make the entries relating to these invoices as at the 1st of the month, although the goods themselves have been received in the previous month ; and care must be taken at balancing periods to ascertain that all goods of this nature brought into stock have been properly dealt with as purchases, or an adjusting entry made to deal with them.

It is customary in most businesses to allow *trade discount.* This discount is an allowance made by one house to another in the same trade, and takes the form of a percentage of the catalogued or fixed price of each article. It varies greatly in different trades, and even on different articles in the same trade, and bears no relation to the payment of cash. The deduction is made from the invoice at the time it is rendered, and in vouching the invoices the auditor should see that only the *net* figure is entered in the Day Book, as trade discount should never, under any circumstances, appear in the ledger.

Cash discount, on the other hand, is an allowance made by the seller to the purchaser in consideration of the latter paying his account at once, or within the period of credit allowed. Such discount, as affecting purchases, is usually recorded in a discount

column on the credit side of the Cash Book, the discount being entered therein, and posted to the debit of the account in the Bought Ledger. Where such discount is regularly taken advantage of, it is sometimes deducted from the invoices before the entry is made in the Day Book. Such treatment cannot be recommended, inasmuch as the ledger account with the creditor will not be found to agree with the statement rendered by the latter; and, moreover, the Discount Account will not record the bought discounts of which advantage has been taken. The argument utilised in favour of this system is that it prevents the deduction of the discount being overlooked, but where there is a proper method in force relating to passing statements for payment, this difficulty should not arise.

(d) Forward Purchases.

In many businesses forward contracts are placed for the purchase of commodities, and in such a case it will be necessary to decide whether provision should be made in the accounts for any potential loss which may arise from a fall in the market price of commodities contracted to be purchased but not yet delivered. Practice is not consistent on this point, but it would seem that so long as a company is merely following its usual procedure in entering into such contracts, and market fluctuations are not abnormal, no special provision need be made for the difference between the contract price and the market price at the date of the Balance Sheet. If, however, *exceptional* forward commitments have been entered into, the outcome of which may adversely affect the financial position of the company, suitable disclosure should be made in the Balance Sheet, and the auditor should qualify his

report if it is not made (*Rex* v. *Bishirgian and Others*. The " Pepper Pool " case). Even though the commitments are not abnormal, if it appears that a substantial loss is probable in connection therewith, the auditor should refer to the matter in his report unless the prospective loss is fully provided for.

§ 2.—Purchase Returns.

The auditor should ascertain that a proper system is in force with regard to the treatment of purchase returns, so as to ensure that full credit is obtained for all goods returned. The departmental manager concerned should send an advice note relating to the item to the counting house, which should be checked by the invoice clerk with the original invoice, the proper entry being made in the Bought Returns Book. If the invoice has not already been paid, the advice note will be attached thereto in order that it may not be overlooked when payment is made. If the original invoice has been paid, a credit note should be obtained from the creditor, and placed with the invoices not yet paid, so that it can be seen that the proper deduction is made from the next payment.

The form of the Bought Returns Book may be of a columnar nature, and similar to that of the Bought Day Book. If this is not convenient, the Bought Returns Book must be analysed, and the auditor, after checking the casts of the book, will check the postings of the totals to the Nominal Ledger.

§ 3.—Sales.

(a) Credit Sales.

The auditor should ascertain the system in force relating to the record of sales from the time that the

order is received until the entry is made in the Day Book. The system adopted will naturally vary with each class of business, but there should be a proper record of all goods sent out, which can be examined with the Order Book, and the prices and extensions should be checked. Much saving of labour is afforded by the utilisation of a system whereby three copies of each invoice are obtained, the first being sent to the customer, the second being utilised as a delivery note, while the third remains in the book, which is used as the Sales Day Book.

Where the nature of the audit requires the whole of the detail to be checked, the Sales Day Books should be cast, and the carry forwards checked, the monthly or other totals of these books being checked to the Sales Account in the Impersonal Ledger. Where, however, the number of transactions involved is considerable, and the system of internal check in connection with the Sales Ledgers, as dealt with hereafter, is satisfactory, it will be sufficient if the auditor tests exhaustively the casts in the Sales Day Books. When all the casts are not checked, all the carry forwards should be.

Where the business is that of a manufacturer or wholesaler, and the goods sold are subject to Purchase Tax, the amount of the Purchase Tax must be disclosed separately on the relevant sales invoices, and should be entered in the Sales Day Book in a separate column, the total of which should be posted periodically to Purchase Tax Account in the Nominal Ledger, which will thus disclose the total amount of Purchase Tax to be accounted for to the Customs and Excise Authorities. The auditor should take care to see that all Purchase Tax has thus been segregated from the sale price of the goods themselves.

Occasionally sales will be made of old plant and machinery, or other assets of a capital nature, the entries being put through the Sales Day Book. Where this is done, care should be taken to see that the total of the sales is correctly analysed, and the amount derived from the sale of capital assets duly credited to the asset accounts in question, since, otherwise, revenue will receive an improper credit.

Where there is reason to suppose that the sales are not *boná fide*, and that entries have been created for the purpose of inflating the profits, the genuineness of the sales can be tested by reference to the Order Book, and to any correspondence that may be in evidence relating to particular orders. The Goods Outwards Book should also be examined, to ascertain that the goods in question have actually left the premises. This test is particularly useful towards the close of the accounting period, in order to discover whether sales really belonging to the succeeding period have been treated as sales at the date of closing the accounts, although the goods themselves may not have been despatched, and may have been included in stock, thus creating a fictitious profit.

(b) Cash Sales.

It has already been pointed out that it is essential there should be an efficient method of recording transactions of this nature. Where the book-keeping system is indifferent, it will frequently be found that the cash sales are merely entered as cash is received, and that there is no method by which the auditor can verify their accuracy. In such cases, he should disclaim any responsibility in connection with the item, and suggest that a proper system be utilised. The vouching of cash sales, where an efficient system is in force, has already been dealt with in Chapter II,

(c) Goods on Sale or Return.

Where goods have been sent to customers on sale or return, the auditor should ascertain that unsold goods in the hands of the customers at the date of the Balance Sheet are not treated as sales, but are brought into account as stock in the hands of customers, at cost price, a percentage being deducted where necessary for damage. It is a primary rule that no credit should be taken in respect of profit on sale until the sale is actually effected. If, therefore, the sale is not completed at the date of the Balance Sheet, no profit in respect of the transaction should be taken credit for.

The proper record of transactions of this nature demands the utilisation of a separate Sale or Return Journal, which should be provided with columns recording the selling price of the goods sent out, the value of goods returned, and the value of goods sold. In such a case, only amounts entered in the sales column should be posted to the debit of the customers' accounts in the Sales Ledger, the other columns not forming part of the double entry. The difference between the totals of the goods sent out column, and the totals of the returns and sales columns taken together at any date, will represent the amount of the goods in the hands of customers at selling price, which, after being reduced to cost, as above-mentioned, should be brought into the Trading Account and Balance Sheet as Stock.

Where the number of transactions is large and the articles of considerable value, it may be advisable to utilise an entirely separate set of books on a double entry basis. Under this system a Sale or Return Ledger will be in operation, the balances on which will represent the goods in customers' hands

at selling price. Such balances, however, must not be brought into the Balance Sheet as book debts, but the goods represented by such balances must be taken to the credit of the Trading Account at cost price or under, and appear on the Balance Sheet as stock in the hands of customers.

It may be found that transactions of this nature are not properly recorded, but are passed through the ordinary Sales Day Books, the sale price being debited to the customers' accounts in the Sales Ledger, corresponding credit being given if the goods are returned. In such a case, the debtors' balances will include goods in the hands of customers at selling price, and the sales will have been correspondingly increased. The auditor should require a schedule of goods in the hands of customers to be prepared, and if it is inconvenient to adjust the individual debtors' accounts in the Sales Ledgers, he should see that an entry is made debiting the Sales Account, and crediting a Suspense Account, with the value of the goods in the hands of customers at the date of the Balance Sheet, at the price at which they have been debited. This will have the effect of reducing the sales to the proper figure, and in the Balance Sheet the credit balance on the Suspense Account should be deducted from the total book debts, thus reducing them to their actual figure. The stock in the hands of customers should then be calculated at cost or under, and brought to the credit of Trading Account, appearing on the Balance Sheet as an asset.

(d) Goods on Consignment.

(1) *Consignor's Books.*

Following the principle that no profit should be taken until the sale is actually effected, where goods

are sent on consignment, the auditor should ascertain that credit has only been taken for profit in respect of goods actually sold prior to the date of the Balance Sheet. In practice, Consignment Accounts sometimes present features of difficulty, and should be subjected to careful scrutiny on the part of the auditor. Where it is desired to show the profit or loss on each consignment, a separate Consignment Day Book should be utilised, the goods sent out being passed through this book at cost, and debited to a Consignment Account. Any freight, insurance, or other expenses incurred by the consignor should also be debited to the Consignment Account; and on receipt of the account sales from the consignee an entry should be made, crediting the Consignment Account with the *gross* proceeds, and debiting the consignee's personal account. The latter account will be credited with the consignee's commission and charges, the Consignment Account being debited. The balance of the Consignment Account will then rèpresent either profit or loss, unless some portion of the goods remains unsold, in which event they should be valued at cost, or under, as the case may be, and brought down as a debit balance on the Consignment Account, which will appear as an asset on the Balance Sheet.

Where consignments are treated in this way, each Consignment Account will represent a Trading Account in respect of the goods sent on consignment, and consequently the sales in connection therewith will not go to the credit of Sales Account. The auditor should ascertain that the goods have been actually debited to the Consignment Account at cost, and inspect the account sales rendered by the consignee, and any account current he may have furnished, which will afford respectively an indication of the sales made,

the stock-on-hand, if any, and the balance of the consignee's personal account.

Although the system above described is the best where it is desired to ascertain the result of each consignment, it is not always adopted in practice. Goods are not, as a rule, invoiced at cost price, but at an estimated selling price, sometimes for the purpose of insurance, and sometimes in order that the consignee shall not be aware of the cost price of the goods. In such cases, it is common to find the goods consigned treated as ordinary sales, and passed through the Sales Day Book, being debited to the personal account of the consignee, who appears as a debtor in the Sales Ledger. If the goods remain unsold, or if the consignment is not closed at the date of the Balance Sheet, and the necessary adjustments are not made, this treatment will be incorrect, as the Sales Account will have been credited, at the selling price, with goods consigned that have not yet been sold, and the consignee will appear as a debtor, whereas he is only liable to account for the proceeds of the goods or the goods themselves. In such a case, the auditor should see that the accounts are properly adjusted, and that consigned stock remaining unsold is brought in at a proper valuation, according to the circumstances.

Where it is not desired to keep a separate account in respect of each consignment, the goods, when invoiced, should not be passed through the books, but should be recorded in a memorandum Consignment Book. No amount should be debited against a consignee's personal account until an account sales is received from him, when a Journal entry should be made, crediting Sales Account and debiting the consignee's personal account with the amount of the sales. A further entry should be made, crediting the consignee with commission and expenses, and debiting

the proper nominal accounts, when the balance of the consignee's account will properly represent a debt due from or to him. It will be observed that, under this system, credit is only taken for goods actually sold, and consequently, stock on consignment remaining unsold must be agreed with the returns furnished by the consignee, and brought into account at or under cost. Similar remarks apply to agents' accounts.

(2) *Consignee's Books.*

In auditing the accounts of a business where goods are received on consignment, and sold on behalf of a principal, the auditor should ascertain that such sales are kept entirely distinct from the ordinary sales effected by the business. A separate Day Book should be kept to record such sales, the total thereof being posted to the credit of the personal account of the consignor, and not to the Sales Account. In the same way, care must be taken to see that no consigned stock is included as part of the stock belonging to the business. For these reasons, it is desirable that no entries should be made in the consignee's books (except the stock record in a Consigned Stock Book) until actual sales are effected, when the various debtors concerned will be debited, and the consignor's personal account credited. Commission and charges will be debited to the consignor, and credited to the respective nominal accounts. The auditor should ascertain by the inspection of contracts, correspondence, etc., the terms of the arrangement, and in cases of importance, a signed copy of the consignor's account should be obtained for the purpose of verifying the balance. It is usually necessary to reconcile the balance of such account with the balance as shown by the Consignee's Ledger, owing to items not yet dealt with by the other party.

(e) Sales for Future Delivery.

In certain businesses contracts are entered into for forward sales, delivery being made, either at stipulated times, or, as and when called for within a certain period. Although a valid contract may exist, it is not desirable that any profit should be taken in advance in connection with transactions of this nature, and the auditor should ascertain that only those goods which have been actually delivered at the date of the Balance Sheet have been treated as sales. This applies particularly where the goods are not yet ready for delivery, and the necessary expenditure has not yet been incurred. Even where the goods under contracts of this nature are ready for delivery at the date of the Balance Sheet, they should be treated as stock and valued at cost price. Cases will sometimes be met with where the purchaser pays cash down for a quantity of goods, but does not take delivery of the whole, leaving a portion with the seller until the goods may be required. In such an event, it may be argued that the whole sale has taken place, and that profit can properly be taken in respect thereof, the goods undelivered at the date of the Balance Sheet not being brought into stock, but being recorded as belonging to the purchaser, and held for his account. The auditor must take all the circumstances into consideration in deciding whether this treatment can be permitted. The most prudent course is to treat as sales that proportion of the goods which has actually been delivered, leaving the purchaser a creditor for the remainder, profit on which will then be taken in the period in which they are delivered.

(f) Sales under Hire Purchase Agreements.

Where hire trading is conducted, it is sometimes the practice to take credit for the full cash selling price

of the goods in the year in which the contract is entered into and to treat the hirer as a debtor for the instalments not yet due at the date of the Balance Sheet. In other cases, Sales Account is credited only with each instalment payable under the contract as and when it becomes due, so that the profit on the contract is spread over the whole period during which the instalments are payable. The latter method is strictly the more correct, as it results automatically in no credit being taken for profit not yet realised. The auditor must, however, be careful, where this method is followed, to see that the amount of the unpaid instalments, reduced by the percentage of profit estimated to be included therein, is credited to the Trading Account and brought into the Balance Sheet as stock out on hire. Where credit is taken at the outset for the full selling price of the goods, provision should be made at the date of the Balance Sheet for an amount equal to the unrealised profit included in the unpaid balances on hire-debtors' accounts, such provision being deducted from the total of such balances in the Balance Sheet. Where the total of the instalments represents the cash selling price plus interest on the diminishing balance of principal outstanding, the auditor should see that credit is taken in each year only for such interest as has actually accrued during the accounting period.

§ 4.—Sales Returns.

The method of recording goods returned by customers should be enquired into by the auditor. A Returns Inwards Book should be kept by the gatekeeper, recording the necessary particulars, which should furnish the basis of the entry made in the Sales Returns Day Book. The latter book should be

cast by the auditor, and the totals checked to the Impersonal Ledger. A certain number of the entries should be tested with the Returns Inwards Book, and in the case of large items, it may be desirable to refer to the correspondence, etc. It should be seen that all credit notes are approved and initialled by a responsible official before being issued. Where stock records are kept, the larger entries should be checked therewith to see that the goods were actually received back.

§ 5.—Packages and Empties.

The method of dealing with packages and empties varies very much in different businesses. Where empties are not returnable, the charge is included, as a rule, in the price of the goods, and is not shown separately. If so, the credit will be included in the Sales Account. If a separate charge is made, either a separate column should be provided in the Sales Day Book, or the sales should be analysed, the proportion relating to empties being posted to the credit of the Empties Account, as against which the cost of the empties will have been debited.

Where the empties are returnable, they should be charged up to the customer, wherever possible; but some customers object to this, and a memoranda system has to be adopted.

As the empties are returned, full particulars will be recorded by the gate-keeper in an Empties Credit Book, which will form the basis of the credit given to the customer, and will be entered either in an Empties Returns Book, or in a separate column provided in the Sales Returns Book. The detail will be posted to the credit of the customer, and the total to the debit of the Empties Account.

The auditor will check the casts of this book, and test a certain number of the entries. It is usual to charge empties at a higher rate than cost price, credit being given, when they are returned, either at this or a lower price. As, however, the outstanding debtors at the date of the Balance Sheet include charges for empties at the higher rate, the auditor should see that a proper reserve is carried forward, representing the difference between the value of the empties outstanding at the rate charged, and the stock value of such empties.

Where packages are not charged up, but are chargeable unless returned, package columns should be provided in the Sales Ledgers, and the numbers of the packages sent to each customer recorded on the debit side of the account. As the empties are returned, corresponding numbers should be entered on the credit side in the memoranda columns; thus the balances on these columns should represent the empties in the hands of the customers at any given date. As the packages are not charged up, there will be no necessity for the auditor to see that any reserve is made in respect thereof, but particulars of the packages in the hands of customers should be extracted at the date of the Balance Sheet, and valued for stock purposes at a proper valuation.

It is desirable that the auditor should test the transactions relating to empties from time to time, in order to see that the system is properly carried out.

§ 6.—Allowances.

One of the commonest methods of concealing cash defalcations, is by putting through fictitious entries under the heading of "Allowances," and it is therefore of the utmost importance that the auditor should

examine the Allowances recorded, in order to ascertain that they are in order.

A separate Allowances or Credit Book should be utilised, which will be written up from the counterfoils or duplicates of the credit notes sent to the customers. Such credit notes or counterfoils should be initialled by the responsible manager of the department concerned, and the auditor should test entries of any consequence where necessary, referring to the correspondence, or to any other evidence available. The Allowances Book should be cast, and the totals checked to the Impersonal Ledger.

§ 7.—The Journal.

The use of the Journal is principally confined to recording opening, closing, and adjusting entries, and all entries of a special nature, for which no separate subsidiary book is in use.

The auditor should check the postings to the respective ledger accounts, and ascertain that each entry is in order. It is necessary that narrative should accompany the entries, explaining their nature, and referring to whatever evidence may be available for the purpose of substantiating them. Such evidence will take the form of correspondence, contracts, minutes, resolutions, etc., and should be examined by the auditor.

This operation is known as vouching the Journal, and in its way is as important as vouching the cash, since Journal entries may be made which have material bearing on the complexion of the accounts.

The following are some illustrations of Journal entries of importance which are continually met with: writing off depreciation, providing reserves for bad

debts, etc., providing for interest on capital, bringing into account outstanding assets and liabilities ; and, in the case of companies, entries relating to the issue of share capital, and the calls made in respect thereof, appropriations of profit, etc.

It is hardly necessary to mention that Day Books, both bought and sold, and Return Books, Bill Books, etc., are all forms of Journals specially ruled to record particular classes of transaction ; another instance being a Transfer Journal to record transfers between one Personal Ledger and another, or one account and another.

The auditor should check the casts of Journal entries composed of more than one item. In some cases, both columns of the Journal are cast throughout the book, for the purpose of sectional balancing, in order that the analysis of the entries relating to each ledger can be proved. Where this is done, it may be advisable for the auditor to check the casts.

In those continental countries where the Code Napoleon is in force, the use of the Journal is compulsory, and all entries, of whatsoever nature, have to pass through this book in one form or another. In this way proper accounts can be prepared at any time from the material embodied in the Journal. The principle of passing everything through the Journal is adopted to some extent in this country, but is usually confined to journalising all the totals of the subsidiary books.

If the Trial Balance is taken out in four columns, the first two columns being utilised to record totals of each side of the account, the remaining columns being utilised to record balances, the operation of the Journal in the manner above described will afford material

assistance in localising errors to the debit or credit side, since the totals of the debit and credit columns in the Journal for the period should equal the totals of the debit and credit total columns in the Trial Balance, if the Cash Book is also journalised.

§ 8.—The Bought Ledger.

In cases where the auditor considers it necessary to check the whole of the detail of the Bought Ledger, the purchases will be checked from the Bought Day Book, the returns from the Returns Book, and the cash and discount from the Cash Book. Entries of a special nature should have been passed through the Journal, and will be checked from that book. The ledger accounts should be examined, to ascertain that every item has been checked by the auditor, including the balances brought forward at the commencement of the period. The ledger will then be cast, and the balances checked with the schedule of creditors or into the Balance Book, if one is kept.

Where it is not considered necessary to verify the whole of the detail work above referred to, the auditor will utilise his judgment as to how far he considers it necessary for his examination to extend. Where the balances on the Bought Ledger can be separately proved, as referred to in § 10, the auditor should check the Total Account representing the Bought Ledger, and see that the balance thereon agrees with the total of the individual balances.

In examining the balances on the Bought Ledger, the auditor should see that the composition of each balance represents some definite item or items. If this is not apparent, and the account is of a complicated nature, it is desirable to examine the last statement rendered by the creditor, and compare it with

the ledger account, in order to see whether there are any items in dispute, in respect of which deductions or reserves ought to be made.

It has already been pointed out in § 1 that a common method of inflating the profits is to include purchases in stock, but to omit them from the Bought Day Book with the result that they are not debited to the Trading Account for the period to which they relate, and the party from whom they are bought does not appear as a creditor on the Balance Sheet. One method of ascertaining whether this has been done has been suggested in connection with the audit of the Bought Journal, but a further check consists in examining the creditors' statements with the Bought Ledger. Where the auditor considers it advisable to verify the balance of an account in this manner, he should call for the last statement, and, if this is not produced, he should insist on a duplicate being obtained.

Where goods which are subject to trade discount have been passed through the Bought Day Book without the deduction of the discount, the auditor should see that the necessary adjustment is made in the ledger account, so that the final credit balance is the amount actually payable.

Debit balances will occasionally be found on the Bought Ledger, representing returns made after the goods have been paid for. If the item has been outstanding any length of time, and no further dealings have taken place, the auditor should ascertain that the amount is recoverable, and does not represent items in dispute, or if it does, that provision is made accordingly. Where the debit balance is occasioned by the payment of cash, the presumption is that the corresponding credit representing the invoice for the goods

has not been passed through the books. Enquiry should be made to ascertain if this is the case, and if so, the outstanding liability should be provided for and the goods taken into stock. Where goods not delivered at the date of the Balance Sheet have been paid for in advance, a credit entry should be passed through the Bought Ledger account, if the property in the goods resides in the purchaser, the goods being taken into stock as in transit, or as in the hands of the seller. Where the property in the goods has not passed, the item may remain as a debit balance.

When mutual dealings take place between two parties, it is usual to find an account in the Bought Ledger for purchases, and one in the Sales Ledger for sales effected. If each account is separately settled by cash, no difficulty will arise, but where the Bought Ledger account is settled by contra, the auditor should check the entry, and examine the voucher acknowledging the contra settlement.

§ 9.—Sales Ledgers.

(a) Internal Check.

It is important for the auditor to ascertain whether there is any efficient system of internal check in operation as regards the Sales Ledgers, as defalcations of cash are frequently concealed by means of fictitious entries. Particular reference should be made to the following points :—

(1) Whether the cashier has any control over the Sales Ledgers, or any books of prime entry relating thereto, other than the Cash Book. If this is so, the opportunities for the concealment of fraud on the part of the cashier are considerable, and the auditor should exercise additional caution accordingly.

(2) Whether the Sales Ledger balances are capable of separate proof, by means of Total Accounts as described in § 10. If so, such accounts should not be under the control of the ledger clerks.

(3) Whether the ledger clerks take any part in checking their own work. Where there is a sufficient number of clerks, no one should be permitted to do this, but in small businesses such an arrangement may be unavoidable.

(4) The arrangements that are in force with regard to the collection of overdue accounts.

(5) Regulations relating to the passing of credit notes for returns, allowances, empties, etc. These have been dealt with above.

(b) The Verification of Postings.

The extent to which the auditor may find it necessary to verify the postings in the Sales Ledgers will depend on the circumstances of each case. Where there is not a good system of internal check in operation, and the transactions are not too numerous, it may be desirable to check the whole of the postings from the books of prime entry to the ledgers. Where this is not practicable, attention should be directed to the credit postings, since any attempt to conceal defalcations will more usually take the form of fictitious credit entries. The cash and discount postings should be checked from the debit of the Cash Book, and this is a convenient occasion for testing discounts allowed, any amounts of importance deducted by way of discount after the term of credit has expired being enquired into. The entries from the Bill Books, Returns and Allowances Books, etc., should also be

checked, and the auditor should go through each account to see that every item is ticked.

Where the Sales Ledgers are numerous, and there is a good system of internal check in operation, it will be sufficient for the auditor to test the postings. This can be done either by checking completely an individual ledger, or by taking individual accounts in different ledgers. It is preferable to check completely accounts that are selected, rather than to rely upon testing individual entries. Note should be taken of the ledgers selected for test, so that in the course of a period of years, the whole of the ledgers may come under notice in this manner.

(c) The Verification of Balances.

However good the system of internal check may be, and although Total Accounts may be in operation, which the auditor may have verified, it is necessary that the individual balances on the Sales Ledgers should also be checked by him on to the schedules, and the schedules cast. It cannot be said that the book debts are properly verified unless the actual accounts representing the individual debts are examined by the auditor.

From the auditor's point of view, it is most convenient if the balances on the Sales Ledgers are brought down at the date of the Balance Sheet, since these can then be checked by him on to the schedules, and there is a clear record in the ledger of the balance of the account at the particular date in question. This is not always done, however, since it is sometimes found more convenient to balance off each account at the time of settlement, rather than at any given date, and the additional labour of bringing down the balances

at an arbitrary date is objected to by the ledger-keeper. Where this is so, the auditor, although he may prefer that the balances should be brought down, is not usually in a position to insist upon this being done, but he is entitled to request that the balance of each account at the date of the Balance Sheet should be inserted in ink at the side of the account, according to whether it is a debit or a credit balance. Even this modest request may be refused occasionally, and the auditor will then be obliged to enter the balance himself in ink at the side of the account, since it is highly undesirable for any balances to be checked on to the schedules without some permanent record of the balance at that date appearing in the ledger account itself.

In extracting the balances it should be ascertained how the composition of each balance is made up, and whether it represents specific items of goods, or is an accumulated balance; and in the latter case, further examination should be made, as to the reason why the account is open; it may be due to errors or disputes in respect of which adjustments or reserves should be made.

Care should be taken to see that no trade discount is included in the balances. If it has been included, the auditor should see that the necessary adjustments are made to reduce the account to the amount which is properly payable. Balances, including goods out on sale or return, goods on consignment, etc., require careful attention, and have already been dealt with in § 3.

(d) Bad and Doubtful Debts.

It is not sufficient for the auditor merely to satisfy himself of the correctness of the balances on the Sales

Ledgers. It is also his duty to ascertain, from the evidence at his disposal, whether any of the balances represent debts which are not recoverable, and whether any are of a doubtful nature, against which reserves should be made.

In examining the balances for this purpose, the following points should be taken into consideration :—

(1) The term of credit allowed by the business.

(2) The age of the debt.

(3) Whether the account is regularly settled within the term of credit, and advantage taken of cash discount.

(4) Whether payments are being made on account, and if so, whether the balance has tended to increase.

(5) Whether an old balance is being carried forward to be paid off by instalments, new goods being supplied for cash.

(6) If payment has been made by bill, whether any bills have been dishonoured or retired.

(7) Whether any cheques have been dishonoured.

(8) Whether any notes have been made on the ledger account relating to suspension of payments, deeds of arrangement, bankruptcies, liquidations, receiverships, or of the placing of accounts in the hands of solicitors or debt collectors.

Where the ledger balances are at all numerous, the auditor, before commencing his examination thereof, should ask that a schedule of bad and doubtful debts be prepared and presented to him, which should be certified by the manager, secretary, or other responsible official, as representing, in his opinion, a complete list

of all doubtful debts for which provision should be made. Having obtained such a schedule, the auditor, as he checks the balances, will be in a position to see whether all those debts which appear to him to be bad or doubtful are included therein, and it will only be necessary for him to make further enquiries in respect of those debts which appear to him to be bad or doubtful, but which are not included in the schedule as such. These should be marked on the schedule of ledger balances, and gone through by the auditor with some responsible official. If no certified list of bad and doubtful debts is presented to the auditor, he should mark on the schedule of ledger balances all those against which he considers provision should be made.

It is impossible to lay down any hard-and-fast rule as to the valuation of book debts. The term of credit allowed in different businesses varies considerably, and may vary even in the same business for different classes of goods; moreover, in certain cases, the terms of credit are not strictly adhered to, or special terms may be granted to individual customers. The auditor, therefore, will require to exercise considerable judgment in arriving at an opinion, and each case must be taken on its merits. Where the average term of credit is three months, but certain accounts are settled half-yearly or yearly, so long as the settlement is regularly effected, there is no reason why the debt should be considered doubtful. Statute-barred debts, although they may in fact be good, should be provided for in full, as there is no legal right to recover them.

If payments have been made on account, and the balance against the debtor continues to increase, the auditor should enquire into the circumstances of the debt, and for this purpose it may be useful for him to

consult any reports from credit agencies and others, as to the amount of credit that can be safely allowed, and where the amount of the debt is within such limit, and the report is of comparatively recent date, the account may be passed. The payment of an old balance by instalments, while new goods are paid for by cash, is nearly always a sign of weakness, and the old balance should, in such cases, be regarded as doubtful, and provided for accordingly. If the debtor has an arrangement of this sort with one house, he probably has a similar arrangement with several of his other creditors, and default of payment of the agreed instalment in any one instance may result in pressure being put upon him, and cause subsequent insolvency.

The fact that bills have been dishonoured or renewed is evidence of weakness. If a provision is considered necessary, and any bills are outstanding on the account, they will, unless discounted, form part of the balance of the Bills Receivable Account, and provision should be made against them accordingly. Where such bills have been discounted, a provision should be made in respect of the contingent liability.

Returned cheques are not necessarily a sign that the account is doubtful, as the return may be due to errors in drafting or indorsement. Where, however, the cheque has been actually dishonoured, and especially where it was in the first instance post-dated, the account should be considered doubtful.

Notes of insolvencies, etc., are usually made at the head of the account concerned for the convenience of the ledger-keeper, and the information to be derived from them is of material advantage to the auditor. In cases where the debt is of any consequence, the papers relating to the matter should be examined, and

the auditor will probably be able to form an opinion from the reports of the trustees, liquidators, etc., as to the proper amount of the provision which should be made. Where final dividends have been declared, the balance of the account should be written off.

The fact that accounts have been placed in the hands of solicitors or agents for collection, does not necessarily imply that the account is bad or doubtful. Unfortunately there are a certain number of people who make a point of never paying until they are sued, and in these cases the account may be perfectly good. The auditor should ascertain the date when the account was put into other hands, as, if any considerable period has elapsed since that time without payment being received, the account may be regarded as doubtful.

It is not desirable that debts should be written off until there is no further hope of recovering anything in respect thereof, since otherwise the account may get overlooked, and any opportunity that may subsequently present itself of recovering the whole, or a portion, of the debt, lost irrevocably.

Further, in the event of such debts being eventually paid, or dividends received in respect of them, opportunity is offered to the cashier to appropriate the sum so received, owing to the fact that no debit appears in the ledger in respect thereof. In order to avoid this possibility, and at the same time to prevent a considerable number of bad debts remaining on the current ledgers, a Bad and Doubtful Debt Ledger is sometimes utilised, to which an account is transferred as soon as it becomes doubtful. In this way a check can be kept on the bad debts, and the ultimate loss in respect of each account ascertained.

Bad debts should not be written off without the sanction of some responsible official, in order to prevent the possibility of misappropriations being concealed by the creation of fictitious bad debts. Bad debts written off during the period should be passed through the Journal, the entries being initialled by the official in question, and checked by the auditor.

As regards the amount of the provision to be made in respect of bad and doubtful debts not written off, the provision should cover the full extent of those debts actually regarded as bad, while the doubtful debts should be provided for according to their estimated value, having regard to the circumstances of each case.

Where the debts are very numerous and of an average amount, the provision for doubtful debts may be made by way of a percentage on the outstanding debtors, the rate of which will be arrived at from previous experience; but this should be supplemented by specific reserves, if necessary.

Where a dividend is received in respect of a debt which has previously been written off as bad, it is desirable that a sum equal to the amount recovered be credited to Bad Debts Account and debited to the debtor's personal account, and for the cash received to be credited to the latter account, in order that a full record of the occurrence shall appear in the personal account for future reference. It is often found that small credit balances unclaimed are written off, after a certain period, to the credit of the Bad Debts Account, though, strictly speaking, repayment should be made. Unclaimed credit balances of any consequence should be carried forward in suspense.

Where the auditor, after careful investigation, is of opinion that the provision for bad debts is insufficient, he should endeavour to induce his clients to make the additional provision which he considers necessary. If, however, he is unsuccessful, his only course is to refer to the matter in his report, stating to what extent he considers the provision is adequate. The question is one of material importance, since it directly affects the correctness of the Profit and Loss Account and the Balance Sheet.

§ 10.—Total Accounts and Sectional Balancing.

In a business of any magnitude, the difficulty experienced in balancing the books is very considerable. unless some method is adopted by means of which the balances of the Sales and Bought Ledgers can be respectively proved. This can be done by the construction of Total Debtors' and Creditors' Accounts, the Total Debtors' Account containing the totals of all items posted in detail to the debit and credit of the Sales Ledgers, and the Total Creditors' Account the totals of all items posted to the debit and credit of the Bought Ledgers. The balance on the Total Debtors' Account should, at the end of any given period, equal the total of the individual debit balances on the Sales Ledgers, less any credit balances ; and correspondingly, the balance of the Total Creditors' Account should equal the net balances on the Bought Ledgers.

The advantages to be derived from utilising a system of this nature are as follows :—

(1) A Trial Balance of the Impersonal Ledger can be prepared, including the balances of the Total Accounts, thus enabling draft or

interim accounts to be drawn out, without taking out the individual personal balances.

(2) Errors can be located.

(3) If these accounts are not under the control of the ledger clerks, they can be made to form an important part of the internal check, for which purpose it is not desirable that they should be recorded at the end of the Sales or Bought Ledgers, as is sometimes suggested, but in the Impersonal Ledger, or in a separate book kept for the purpose.

For the effective operation of this system it is essential that every transaction recorded in the ledgers should first be passed through a book of prime entry, since it is from the totals of the books of prime entry, as relating to the Sales and Bought Ledgers respectively, that the Total Accounts must be compiled. No transfers, therefore, should be made in these ledgers without passing either through the Journal, or through a separate Transfer Journal.

(a) Total Debtors' Account.

On the debit side of the Total Debtors' Account will be found—

(1) The opening debit balance brought down from the previous period, which should agree with the total of the last schedule of debtors.

(2) Sales from the totals of the Sales Day Books.

(3) Cash payments, returned cheques, etc., from the analysis of the payments side of the Cash Book.

(4) Dishonoured bills, transfers, interest, discount, etc., which will be obtained from the analysis of the Journal or Transfer Journal.

On the credit side of the Total Debtors' Account will be found—

(1) Opening credit balance (if any), representing the total of the balances which were in credit at the close of the preceding period.

(2) Cash received in respect of debtors. In order to obtain the total of the cash received, a separate column should be provided in the Cash Book, in which should be extended all items relating to the Sales Ledgers.

(3) Discount payable from the totals of the discount column on the debit side of the Cash Book.

(4) Returns inwards and allowances from the totals of the respective Day Books.

(5) Bills Receivable from the Bills Receivable Book.

(6) Bad debts, transfers, and other special items (if any) from an analysis of the Journal or Transfer Journal.

The balance of the Total Account, so compiled, should equal the net total of the individual balances on the Sales Ledgers. If there is any difference, either the Total Debtors' Account is incorrect, or there is some error in the Sales Ledgers. The correctness of the Total Account is *primâ facie* proved if the Impersonal Trial Balance, which should include the balances of the Total Debtors' and Creditors' Accounts, agrees. At the same time, if there is any error in the cast of those books of prime entry, the totals of which are posted to the Impersonal Ledger, such error will be counterbalancing, and will not affect the Trial Balance of the Impersonal Ledger, though it will cause the

Total Debtors' Account to disagree with the balances on the Sales Ledgers. For instance, the Sales Day Book may be overcast £100, but as the total is posted to the credit of Sales Account and to the debit of the Total Debtors' Account, the error will not be discovered by the Impersonal Trial Balance. It is therefore essential that all the casts of the books of prime entry should be checked before it is assumed that the error resides in the Sales Ledgers.

(b) Total Creditors' Account.

On the credit side of the Total Creditors' Account will be found—

(1) The opening credit balance brought down from the previous period, which should agree with the total of the last schedule of creditors.

(2) The purchases from the totals of the Bought Day Book.

(3) Transfers and other special items from the analysis of the Journal or Transfer Journal.

On the debit side will be found—

(1) Opening debit balance (if any) brought down from the previous period.

(2) Cash paid to creditors, the totals being derived from a special column provided on the credit side of the Cash Book, into which all payments relating to the Bought Ledger should be extended.

(3) Discount receivable, from the totals of the discount column on the credit side of the Cash Book.

(4) Bills payable, from the total of the Bills Payable Book.

(5) Returns outwards and allowances, etc., from the totals of those books.

(6) Transfers and other special items from the analysis of the Journal or Transfer Journal.

The closing balance should equal the net balances on the Bought Ledger.

(c) Sectional Balancing.

In small businesses, where there are only a few ledgers, the system of compiling Total Accounts for debtors and creditors respectively is sufficient for all practical purposes, but, as soon as the number of ledgers increases, some further extension of the principle becomes necessary, if balancing is to be effected accurately and promptly. Where, for instance, there are five Sales Ledgers, only one Total Debtors' Account being compiled, representing the whole of these ledgers, and it is found that a difference exists, there will be no means of locating the difference as between one ledger and another. In order to overcome this difficulty, *separate* Total Accounts should be compiled for each particular ledger.

Where the number of ledgers employed is not very great, it is sometimes found possible to provide separate columns for each ledger in the Cash Book, and other books of prime entry; but this method becomes too cumbersome where the ledgers exceed three or four in number, owing to the space occupied by the rulings. It therefore becomes necessary to adopt some system of analysis, or alternatively, to subdivide the books of prime entry, so that one book is used for entries relating to one or two ledgers only. If the books of prime entry are not sub-divided, each book should, at the end of every month, be analysed

for the entries it contains relating to each ledger, and a summary prepared thereof, the total of which should agree with the total of the book of prime entry. When the figures of the analysis are agreed, the totals relating to each ledger should be entered in a Summary Book, which should have separate columns or pages for each ledger. When all the requisite totals have been inserted, and the balances relating to each ledger carried forward from the preceding period, the final balance relating to each ledger should agree with the net balances on that ledger, and in this manner Total Accounts for each ledger will be constructed.

Where systems of the nature above described are in force, the auditor's work in connection with the Personal Ledgers will be materially facilitated. The Total Accounts will be checked or tested, and it should be seen that the balances thereof agree with the net balances on the Personal Ledgers. If it is arranged that the clerks who take out the ledger balances should not be concerned with the posting of those particular ledgers; that no ledger balances should be extracted by the clerk who prepares the analysis for entry in the Summary Book; and that that book is under the control of some responsible official, no ledger clerk being allowed access to it, the internal check will be a very effective one, and it will be unnecessary for the auditor to spend much time in checking the detail of the Personal Ledgers.

§ 11.—Loose Leaf and Card Ledgers.

The utilisation of loose leaf ledgers is now very usual, and in many cases these undoubtedly possess considerable advantages over ordinary ledgers.

The main advantages to be derived from utilising loose leaf ledgers are, that it is unnecessary to open new ledgers altogether at any one date, owing to the fact that the ledgers are continuous, additional pages being inserted as required; and that closed and dead accounts can be withdrawn from the ledger and filed separately, thus avoiding a large number of such accounts being retained in the current ledgers.

On the other hand, the system is subject to certain disadvantages. There is a possibility of sheets being accidentally lost or destroyed, though this should not occur where proper supervision is maintained. A more serious danger exists in the possibility of fraudulent substitution of one sheet for another, in order to conceal defalcations, and the auditor should make enquiries into the system in force for the custody of unused sheets. The keys of the ledger should be kept under the sole control of some responsible official, and similar control should be exercised over the stock of loose sheets. No sheet should be taken out of any ledger until the matter contained therein has been passed by the auditor. All sheets so withdrawn should be filed in order.

It has been suggested that loose leaf ledgers might not be deemed sufficient evidence in a Court of Law, owing to the possibility of substitution, but as the entries in any account can usually be substantiated by other evidence, this point need not seriously be considered.

Card systems differ from loose leaf systems, inasmuch as each ledger account is contained on a card, the cards themselves being filed in cabinets. The disadvantage of this system is, that whenever an entry has to be made, the card has to be taken out of the

cabinet for the purpose of writing on it, and as this operation has to be effected continuously, the same measure of control cannot be exercised to avoid the possibility of substitution or loss. As a result, the system is more adapted to memoranda purposes than to actual account-keeping, though where there are a very large number of accounts, the entries in which are comparatively infrequent, it may be found convenient. In other respects the same remarks apply to the card system as to the loose leaf system referred to above.

Another advantage which card ledgers undoubtedly possess over ordinary ledgers, is that at balancing periods the work of checking and agreeing the accounts can be divided over as large a number of clerks as the prime entry records permit. This may save considerable time, and prevent the current work getting into arrear. Such a procedure should not be allowed with loose leaf ledgers since this would involve unlocking the binders and leaving the leaves free; but separate binders, in which the leaves can be locked during use, can be provided to enable the work to be divided if it is desirable.

§ 12.—Mechanical Systems.

It is not considered to be within the province of this work to deal in detail with the systems of accounting by the use of machines, which are being utilised to an increasing extent in large businesses. These enable an effective system of internal check to be instituted by the automatic balancing of the accounts, either in sections or as a whole, at daily or such other intervals as may be desired.

The introduction of a system of mechanical accounting does not affect the main principles of

the audit, but the methods adopted by the auditor of verifying transactions may have to be varied by reason of the change in the system of making original records.

From the auditor's viewpoint, a mechanised system of accounting has the following disadvantages :—

(1) The books consist almost entirely of loose sheets or cards, and unless there is a thoroughly efficacious system of internal check with regard thereto, the opportunities for fraudulent substitution or destruction of records are almost illimitable. There may also be a risk that originating documents may never reach the machine operator. The auditor must therefore make very careful enquiry into the system of dealing with these matters before preparing his audit programme.

(2) An error in an original entry will pass automatically throughout the whole of the records and will not be brought to light by the failure of one set of figures to agree with another.

(3) Less detailed narrative is normally provided than in the case of hand-written records, and time may be wasted in elucidating doubtful items.

(4) Frequently the only permanent record of a transaction is a carbon copy, which can easily be altered.

On the other hand, the work of the auditor may be facilitated by the greater legibility of machine-made entries, and, provided the system of control over original records is adequate, the auditor need not devote nearly so much time to the checking of casts and of the balances of accounts.

As an illustration of the manner in which the detailed work of the audit may have to be modified where a system of mechanical accounting is employed, the procedure with regard to sales records may first be considered. The sales invoices are typed and carbon copies thereof are provided, which form the originating documents for the book-keeping entries. From these carbon copies the book-keeping machine, in one operation, debits the customers' accounts, writes up the Sales Day Book Sheet, and makes the appropriate entries on the statements to be sent to debtors at the end of the month or other period. The total amount of the items is accumulated in the machine, and forms the basis of the postings to the Sales Ledger Control Account and to the Sales Account in the Nominal Ledger. It will thus be apparent that, in the absence of any mechanical defect in the machine, the total of the debits to the personal accounts will agree automatically with the total amounts posted to the Control Account and the Sales Account, and it is therefore unnecessary for the auditor to check in detail the individual postings, although a certain amount of test-checking may be desirable.

It is possible, however, for errors to be made in the figures posted in respect of individual sales, and some independent check is necessary to bring such mistakes to light. It is therefore essential that a " pre-list " of the amounts of the invoices be made on an adding machine, and that the total of this list be agreed with the total shown by the ledger posting machine.

Similarly, with regard to remittances from customers, a machine may be used to write up the official receipts, and to prepare pre-lists of the sums received. Postings to the customers' accounts are made by

machine from these lists, and the totals thereof agreed with the totals accumulated in the machines, which are posted to the Control Account and to the Total Cash Account.

In the case of purchases, the invoices received are first sorted alphabetically, and a "pre-list" made, as in the case of sales. The invoices are then passed to the operator of the book-keeping machine, who posts the amount of each invoice to the credit of the supplier's account, and in the same operation enters it on the Purchases Day Book Sheet. The machine will also produce and print at the end of the Day Book Sheet the total of the items, which will be posted to the Control Account and to the Purchases Account in the Nominal Ledger. This total is checked with the total shown by the pre-list. A similar procedure is followed with regard to payments to creditors, the pre-list of the payments being reconciled with the Cash Book Sheet produced on the posting machine.

It will be obvious that under such a system it is unnecessary for the auditor to check all the casts of the Day Books, but as a precaution he should test a certain number of the sheets, and should be careful to compare the totals thereof with those of the pre-lists. Neither should it be necessary for the auditor to check in detail the balancing of the accounts in the Debtors' and Creditors' Ledgers. Under a mechanised system each such account is automatically balanced, and the balance extended, every time an entry is made, and provided the auditor is satisfied that the machine is performing its functions and that there are no loopholes for omissions or fraudulent manipulation, this balance may be accepted. The time saved by not having to check the casts and balances of the accounts

may be usefully employed in scrutinising their composition in order to bring to light any possible irregularities, and, in the case of the Debtors' Ledgers, to verify the provision for bad and doubtful debts.

The Impersonal Ledger, even though written up by machine, should be checked in detail by the auditor, and, as a general rule, no variation from the procedure followed in the case of hand-written records is recommended.

In the Punched Card system of accounting, the principal machines employed are the punch, the sorter and the tabulator. The punch is used to punch holes in the cards in such positions that they correctly record the transactions represented by the particular cards, *e.g.*, a card recording a sale will be furnished with columns for date, customer's number (and/or folio), description or reference number of article sold, quantity, price, total amount, traveller's number, etc. The accuracy of the position of the holes punched is checked by being repunched by a verifier.

The cards recording similar transactions, *e.g.*, sales, can then be analysed in any way desired by means of the sorter. The cards may be sorted under customers' numbers for posting to the ledger, re-sorted under commodity numbers for posting to the Stock Ledger, under travellers' numbers for preparation of commission sheets, and for any other purpose that may be desired.

When all the cards relating to a particular customer have been collected, the cards, the ledger sheet, and an invoice form are inserted in the tabulator. This machine translates the holes in the card into words and figures, and prints all the relevant information from the card simultaneously on the ledger account

and invoice form. A master card can also be produced by the tabulator, punched so as to represent the total of the items relating to the customer in question. This card can then be used, *inter alia*, for the purpose of preparing the statement in due course.

Where the Punched Card system is employed, the auditor should first satisfy himself that the internal check is such as to ensure that all original records reach the operators of the machines, and that cards are repunched by a verifier before being dealt with further. All information on the original documents should be listed on an adding machine, and agreed with the total obtained by listing and totalling the punched cards on the tabulator. In order to test the accuracy of the punching, the auditor might also select a number of cards and put them through the machines himself, or require an operator to do so under his supervision. All parts of the records should be tested in this way,. particular attention being given to the Debtors' and Creditors' Control Accounts, the balances on which should be compared with the lists of balances on the individual personal accounts. As already stated, the entries in the Impersonal Ledger should be verified in detail.

CHAPTER IV

THE AUDIT OF THE IMPERSONAL LEDGER

§ 1.—The Impersonal Ledger.

In the two previous chapters, the duties of the auditor in relation to the examination of the books of prime entry and the Personal Ledgers of a trading business have been considered, and it is now proposed to deal with the Impersonal Ledger, and the points that will require to be considered by the auditor in connection therewith. The verification of assets is a subject of great importance, and will be more conveniently dealt with in the succeeding chapter. Similarly, questions particularly affecting limited companies will more properly be considered in the chapters dealing with company audits. There remain, however, a large number of questions common to most classes of accounts, which particularly affect the ascertainment of profit or loss, and involve the consideration of important principles.

Ledger accounts may be divided primarily into two classes—Personal, and Impersonal.

Personal Accounts record dealings with persons, and, in the case of a trading business, consist principally of the accounts of persons from whom goods are bought, or to whom goods are sold, being recorded in the Bought and Sales Ledgers respectively. There remain, however, a certain number of personal accounts which will be found in the Impersonal Ledger, such as Loan Accounts, Partners' Capital and Current Accounts, etc.

Impersonal Accounts record the aspect of transactions as they affect the business, and not as they affect persons, and may be subdivided into *Nominal Accounts*, which relate to profit or loss, and *Real Accounts*, which record assets.

The Impersonal Ledger, therefore, should contain the whole of the accounts affecting the composition of the Trading and Profit and Loss Account, and all accounts representing assets and liabilities, other than those contained in the Personal Ledgers. The term Impersonal Ledger is not always utilised; sometimes the term General Ledger is employed, and in certain cases a Nominal Ledger will be found, which should only contain accounts relating to profit or loss. In most businesses a Private Ledger is utilised to contain accounts of an essentially private nature. Such variations of detail will be determined according to the convenience of each particular business, and the term Impersonal Ledger is here employed to cover all those accounts not included in the Personal Ledgers.

Except in very large businesses, the amount of detail in the Impersonal Ledger is not excessive, and the auditor will be able to check the whole of the entries. This is important, since, if the auditor is able to verify the correctness of the impersonal accounts, this fact in itself will go a considerable way towards proving the correctness of the personal accounts, at any rate in total, since one of the commonest methods of concealing manipulations in personal accounts is to make a corresponding fictitious entry in an Impersonal Account.

The entries in the Impersonal Ledger will come either from the totals of the subsidiary books of prime entry, from the Journal, or from the Cash Book. The casts of the various books of prime entry, such as the Bought and Sales Day Books, Returns and Allowances

Books, Bill Books, etc., having been verified, the monthly totals thereof should be checked to the accounts in the Impersonal Ledger to which they relate. Where the totals have been subject to analysis, such analysis should be cast and proved, and the individual items composing it checked to their respective accounts in the Impersonal Ledger.

Many important transactions of an impersonal nature are recorded through the Journal. The vouching of such entries has already been dealt with, and when this is being performed by the auditor, he should see not only that there is sufficient evidence available for the entry, but that the entry itself properly records the transaction. If this has been done, the actual checking from the Journal into the Impersonal Ledger becomes a matter of detail. In order to avoid a multiplication of entries in the Journal, it is common to find many transactions of an important nature recorded by means of a mere transfer from one account to another in the Impersonal Ledger. This practice cannot be recommended. The tendency to reduce the number of entries in the Journal as much as possible for the purpose of saving labour, though admirable in itself, may be carried too far, and it will frequently be found, where transactions of an important nature are recorded by direct transfer in the Impersonal Ledger, that no narrative is inserted explaining the origin and nature of the entry. Such a transfer, however, may have the most important consequences on the accounts. An item may be transferred from the credit of a revenue account to the debit of an asset account, thereby directly affecting the profits of the undertaking. The auditor should, therefore, examine and vouch such transfers in the same manner as if they had been passed through the Journal. The

postings from the Cash Book to the Impersonal Ledger should be checked in detail. It has already been remarked that, when vouching the Cash Book, the auditor should particularly observe each item not posted to a Personal Account, and satisfy himself, from the nature of the evidence available, that the account to which it has been posted in the Impersonal Ledger is the correct one. Frequently, however, the particulars recorded in the Cash Book are insufficient to indicate the account to which the item should be posted. In such cases it is advisable for the auditor to note against the item sufficient particulars to enable him to assure himself, when the posting is checked, that the item has gone to the correct account.

The whole of the postings having been checked, and the ledger accounts examined to see that every item has been ticked, the casts should be verified, and the auditor will then be in a position to check the balances.

In cases where the books are presented to the auditor balanced, and accounts prepared for submission to him, it is advisable that he should not examine the Impersonal Ledger until the whole of the entries have been completed, the necessary adjustments made, and the accounts closed off. He can then check the balances direct to the Trading and Profit and Loss Account, the Balance Sheet and its schedules. In many cases, however, the auditor is called upon to act in the capacity of accountant, and make the necessary adjusting entries; draft out final accounts for submission to his clients, and close the Impersonal Ledger when these have been approved. Where this is so, the auditor will check the balances of the Impersonal Ledger to the Trial Balance that is produced to him, and utilise that as a basis from which to make

the necessary adjusting entries and prepare the final accounts.

The distinction between the auditor, in his capacity as auditor, and in his capacity as accountant, has already been referred to in Chapter I, and need not again be discussed here; but whether the auditor makes the adjusting and closing entries, or merely audits them, he must satisfy himself that those entries are correct, and that all the necessary adjustments, of which he has knowledge, have been made.

§ 2.—Outstanding Liabilities and Assets.

In a business of any size, there is always a considerable number of adjustments to be made on the occasion of each balancing period, for the purpose of properly recording outstanding liabilities and assets, which for some reason or other have not already been brought into the accounts. In such cases it is very convenient to utilise a memoranda book, which may be termed an Outstandings Book, in which all particulars of outstandings are entered at each balancing period, and which can thus be made to form the basis from which the adjusting entries are constructed. Such a book will be found particularly useful by the auditor, as it will afford a ready means for the comparison of outstandings as between one period and another, and act as some sort of reminder of the nature of the adjustments usually necessary in the particular business concerned, which will not as a rule be found to vary very much from year to year.

Where an Outstandings Book of this nature is in force, it is advisable for the auditor to obtain a certificate from some responsible official, to the effect that all the outstandings within his knowledge that require

to be dealt with have been included therein. Such a certificate will not relieve the auditor from the necessity of exercising reasonable skill and diligence in the matter, but he cannot possibly be aware of all the outstandings, and the certificate serves to fix the responsibility for any omission.

Where an Outstandings Book of this nature is utilised, the necessary entries can be made direct in the Impersonal Ledger, reference being made to the folio of the Outstandings Book for the narrative relating to the entry. In the absence of such a book the entries should be recorded through the Journal, the necessary narrative being inserted. As regards outstanding liabilities, it is very usual to find the various impersonal accounts debited, and a Sundry Creditors Account credited. This method, however, although perfectly sound and convenient at the date of closing the books, involves writing back the entries at the commencement of the next period, since the items are not always identical with the payments made. It is preferable, therefore, to bring an outstanding liability down as a credit balance on the impersonal account concerned, and in a similar manner to bring an outstanding asset down as a debit balance. Care should be taken that such balances are treated as liabilities and assets respectively in the preparation of the accounts.

(a) Outstanding Liabilities.

The inclusion of all known liabilities in the accounts is of great importance, inasmuch as it directly affects the correctness of the Profit and Loss Account and/or the Balance Sheet. It is therefore one of the duties of the auditor to ascertain that all outstanding liabilities are dealt with. At the same time this

is not always an easy matter, as a liability may be suppressed or concealed and the books may contain no indication of its existence. There are, however, certain classes of outstanding liabilities which are common to most businesses, and the existence of which, though not recorded in the books, should be apparent to the auditor from the nature of the transactions. The existence of other liabilities, though not so apparent, may be suggested to the auditor by his experience. The more usual of these will now be dealt with.

(1) *Purchases.*

In some instances invoices relating to purchases that have been taken into stock are received too late to be included in the Purchases Day Book before the accounts are closed, and may consequently have been entered in the succeeding period. A schedule of these should be prepared, and the total debited to the Purchases Account, and brought down as an outstanding liability. Where the precise amount of the liability cannot be ascertained, an estimate should be made and signed by some responsible official.

(2) *Wages.*

In the case of a manufacturing business, where the date of the Balance Sheet happens to fall in the middle of the wages week, the proportion of wages accrued should be calculated and brought in as a liability.

(3) *Rent, Rates, etc.*

It should be seen that all rents payable have either been paid to the last quarter day, or that the outstanding rent is brought in as a liability. Where the date, on which the accounts are closed, falls between the

dates at which the rent is payable, the rent accrued to date must be calculated and brought into account, though it will not be payable till the succeeding quarter day. The same remarks apply to rates, though, as these are usually payable in advance, the adjustment necessary will then come under the heading of outstanding assets. On the occasion of the first audit, it may be found that expenditure of this nature has been dealt with on a cash basis in the past, and that the inclusion of the outstanding liabilities will result in the current period being charged with a greater proportion than properly relates to it. Notwithstanding this, the accounts should be adjusted, special note being made of the additional charge incurred by reason thereof. The accounts will then be placed on a correct basis, and the Balance Sheet will show the true position of affairs.

The treatment of Income Tax is dealt with in Chapter VII, § 17.

Where the business premises are rented and the Schedule A tax is assessed on the occupier, it should be seen that the tax paid has been debited to Rent Account and deducted from the next payment of rent. Where the Schedule A tax exceeds the next payment of rent, the occupier may claim to pay the amount of such excess on 1st April, instead of paying the whole of the tax on 1st January, so that the excess may be recovered from the next payment of rent following 1st April. Where the accounts are made up to a date between the date on which Schedule A tax has been paid and the date on which it can be recovered by deduction from rent, it must be seen that the recoverable Schedule A tax is carried forward as an asset, and not written off to Profit and Loss Account.

(4) *Freight.*

Carriage and freight accounts may not be rendered till some time after the period has elapsed to which they relate, and it is often necessary to close the accounts before they are received. In such a case, the amount outstanding must be estimated, and a comparison with the corresponding items of the previous year will afford a useful indication of the probable amount outstanding, if the business is of a regular nature. Payments for freight are usually posted direct to the impersonal account, and the auditor should be able to ascertain, from his examination of the freight account, the period in respect of which any liability is outstanding.

(5) *Trade Expenses.*

A schedule of the expenses outstanding should be prepared, and the total brought down as a liability on the Trade Expenses Account. It will be found, usually, that certain classes of expenditure are outstanding, particularly where no personal accounts are kept in the Bought Ledger for the creditors concerned.

(6) *Legal Expenses.*

Solicitors frequently allow some time to elapse before sending in accounts to their clients, and consequently legal expenses may be outstanding, and should be provided for. Where no account has been received from the solicitor, an estimate of the amount of his costs up to the date of the Balance Sheet should be obtained from him.

(7) *Audit Fee.*

The question as to whether the audit fee relating to the period covered by the accounts should be brought in as a liability at the date of the Balance

Sheet has been much discussed, and still remains an open point. In some cases the audit may not have been commenced till after the date at which the accounts were closed, in which event it cannot properly be said to be a liability at the date of the Balance Sheet. In any case only a part of the work will have been performed. On the other hand, the work involved relates to the period covered by the accounts, and it is certainly advisable that the audit fee should be treated as an outstanding liability. Similar remarks apply to accountancy charges for the preparation of the accounts, etc. In cases where the fee has not yet been agreed upon, but is dependent on the amount of work involved, an estimated amount may be brought in as outstanding.

(8) *Travelling Expenses.*

A schedule should be compiled of all travelling expenses due to travellers and others up to the date of the Balance Sheet, and these can be verified by the auditor, since they will probably have been paid early in the succeeding period.

(9) *Travellers' Commission.*

The Travellers' Commission Account in the Impersonal Ledger should be examined and tested with the Commission Books relating to each traveller. It will be found, usually, that the commissions in respect of sales for the closing month of the period will not have been paid till the succeeding month, and the amounts due must therefore be brought in as outstanding. If any sums have been paid to individual travellers on account, only the balance of the commission due should be brought into account. Sometimes it is found that the advances exceed the amount of commission payable, and in that case the excess of

the amount advanced over the amount due is in effect a loan, and should be brought down as an outstanding asset, and treated in the Balance Sheet as a debtor, provision being made where necessary. The system of allowing travellers to collect debts and set off the amount so collected against the sums due to them for commission and expenses, is very undesirable, and the auditor should recommend its discontinuance. Where it is in force, the auditor should ascertain that the various debtors' accounts have been credited, and commission and expenses accounts debited, with the amounts retained.

In some cases a traveller is not paid commission until the goods ordered through his agency have been paid for in cash ; in other cases part of the commission is paid on execution of the order, and the balance when the goods are paid for.

Where arrangements of this nature are in force, the auditor should ascertain that proper provision has been made for outstanding commissions that will become payable in respect of goods sold prior to the date of the Balance Sheet.

Sometimes the arrangement with the traveller provides that returns, allowances, and bad debts in respect of orders upon which commission has already been paid are to be brought into account in arriving at the current commission. If this is so, the auditor should ascertain that the proper deductions have been made.

(10) *Interest on Loans.*

All interest due or accrued should be calculated at the proper rate, and brought in as an outstanding liability.

(b) Outstanding Assets.

There are two classes of outstanding assets which may require to be dealt with : firstly, items accruing or due, not recorded in the books, which will ultimately be received in cash ; and, secondly, expenditure already incurred, some portion or the whole of which relates to a period subsequent to the date of the Balance Sheet. The latter class is usually termed *expenditure paid in advance*, and the items of which it is composed should be shown in the Balance Sheet in one total under that heading. On no account should such items be included as Sundry Debtors. In order that the Profit and Loss Account may be correctly stated, it is important that on the one hand only expenditure relating to the period under review is included, and that on the other hand all income accruing, that is reasonably certain to be received, is brought into account. It is inadvisable, however, to bring into account any income due or accrued which is not likely to be received, unless at the same time it is fully provided against.

Expenditure which is not strictly apportionable in respect of time, but the benefit of which has not been entirely received during the period under review, may in many cases be properly carried forward in suspense, and written off over a period of years. The treatment of such items will be dealt with in § 4.

The following are the more usual classes of outstanding assets :—

(1) *Rents Receivable.*

All rents receivable due or accrued to the date of the Balance Sheet should be calculated and brought into account, provision being made for doubtful or irrecoverable arrears, allowances for repairs, Schedule A Income Tax, etc.

(2) *Interest and Dividends.*

Interest receivable on loans accrued to the date of the Balance Sheet should be brought into account in all cases where the interest is regularly paid on the due dates. If the interest is in arrear, the amount accrued should either be omitted, or brought into account, and a corresponding provision made against it. Dividends on stocks bearing a fixed rate of interest, which it is known will be received in due course, may be calculated and brought into account, in-so-far as they are accrued at the date of the Balance Sheet. Dividends on ordinary shares, however, should not be brought into account unless they have been received subsequently, when the amount so received can be apportioned.

(3) *Commission Receivable.*

Commissions due or accrued should be brought into account, but before passing the item the auditor should examine the basis on which the calculation is made, and satisfy himself that the amount will be duly received.

(4) *Rents, Rates, etc., paid in Advance.*

Rent is sometimes payable in advance, and the amount so paid relating to the period subsequent to the date of the Balance Sheet can be carried forward. Rates, etc., are usually payable in advance, and where paid prior to the date of the Balance Sheet, similar considerations apply as in the case of rents paid in advance. The auditor should examine the demand notes to ascertain the period to which the rates, etc., apply.

(5) *Insurance Paid in Advance.*

Insurance is payable in advance, and in the case of a large business the premiums payable in respect

of fire, burglary and workmen's compensation may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated, and brought down as an outstanding asset. The last premium receipts will have been inspected in the course of vouching, and the auditor should refer to the actual policies if he considers it desirable.

(6) *Advertising.*

Payments are frequently made in advance under advertising contracts, and the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be carried forward. Stock of advertising material, such as posters, signs, samples, etc., if not obsolete, may be valued at or under cost, and carried forward as an asset, depreciation, where necessary, being allowed for. This subject is further considered in § 4 (*b*).

§ 3.—Apportionment of Expenditure between Capital and Revenue.

The distinction between capital and revenue is of vital importance as affecting the amount of profit or loss, and the correctness of the Balance Sheet.

Capital Expenditure may be said to be all expenditure incurred for the purpose of acquiring assets of a permanent nature, by means of which to carry on the business, or for the purpose of increasing the earning capacity of the business.

Revenue Expenditure is all expenditure incurred in carrying on the business, and in maintaining the capital assets in a state of efficiency.

The allocation of expenditure as between capital and revenue calls for the auditor's careful examination. Where the expenditure is directly incurred for

capital purposes, it can be vouched by the auditor in the course of his examination of the Cash Book, or the Bought Journal, and his duties in this connection have already been dealt with. In many cases, however, the expenditure takes the form of wages of workmen either wholly or partially employed on capital improvements and extensions, but whose wages are included in the general Wages Account. Unless, therefore, a transfer is made from the Wages Account to the debit of the asset account concerned, revenue will be charged with wages which may properly be capitalised. Before passing any such transfer the auditor should examine the basis upon which it has been calculated. In these cases general estimates are unreliable and insufficient; precise particulars should be furnished of the number of men employed, the nature of their work, rate of pay, etc., and the proportion thereof applicable to capital. Such analysis should be certified by the wages clerk as to calculations, and by the foreman as to the work done and the nature thereof, and finally by the works manager as being correct, and properly chargeable against capital. Expenditure in the shape of wages on repairs or renewals should be charged to the Repairs and Renewals Account, and not to the asset account.

Similar considerations apply to expenditure on materials which cannot be directly allocated to capital purposes at the time of purchase. Schedules of all goods taken from store for such purposes should be prepared by the storeskeeper and certified by the works manager, the values being calculated at cost price.

Where expenditure of this nature amounts to a considerable sum, it is advisable for the auditor to refer to the matter in his report, stating that he has accepted the certificates of responsible officials as to the correctness of the allocations.

Where obsolete plant is replaced, the cost of pulling down the old plant should be charged to the old plant account, and the cost of erecting the new, to the new plant account. The balance of the old plant account, less any credit for the residual value of the old plant, will represent a loss, which should be written off to revenue at once, or over a short period of years.

§ 4.—Deferred Revenue Expenditure.

Reference has already been made to certain classes of expenditure which are primarily of a revenue nature but the benefit of which is not exhausted during the period covered by the Profit and Loss Account. Such expenditure may be conveniently termed *deferred revenue expenditure*, and it may be carried forward and written off within the period during which the benefit arising from it is likely to be felt, in order to avoid an unduly heavy charge being made against the profits in any one year.

Where it is proposed to carry forward expenditure of this nature, the auditor should enquire into the facts of the case before he permits this treatment to be adopted, since it is sometimes resorted to for the purpose of inflating the profits.

The following are specific instances where this method may be utilised :—

(a) Alterations to Plant.

Heavy expenditure may be incurred for the purpose of improving plant and machinery, or adapting the same to altered conditions of trade, which cannot be strictly regarded as capital expenditure, but which does in a sense improve the earning capacity of the business. This expenditure may be carried forward, and written off over a period of years, say from three to five, where no provision already exists in the shape

of Depreciation or Renewal Funds, against which it may be debited. The nature of the expenditure should be clearly stated in the Balance Sheet, and the auditor should draw attention to the treatment of it in his report.

Similar considerations may apply in the case of heavy renewals occasioned by scrapping obsolete plant.

(b) Advertising.

Abnormally heavy expenditure on advertising is frequently incurred in the course of establishing a new business. Where such expenditure is on a large scale, it is in fact a form of capital expenditure, and may actually be capitalised under the heading of Development Expenditure or Advertising Goodwill. Goodwill of this nature, however, cannot be maintained unless considerable advertising is continued in subsequent years, and therefore a certain proportion should be written off to Profit and Loss. The balance may be carried forward permanently as an asset, though it is preferable to write it off over a period.

Where the expenditure on advertising is not incurred for the purpose of creating an entirely new business, but is nevertheless of an abnormal nature owing to the placing of some new product on the market, or the opening of some new department, the average annual charge for advertising should be estimated, and such amount written off to Profit and Loss, the balance being carried forward and appearing separately in the Balance Sheet as Advertising Suspense. The auditor should ascertain that the amount so written off is adequate, and that the Suspense Account is not carried forward over an unreasonable length of time.

Similar considerations apply to businesses where the advertising is not continuous, but heavy expenditure is incurred from time to time. In seasonal trades,

expenditure may be made in connection with a new season, the benefit of which may not be felt before the accounts are closed. In such cases a proper proportion of the expenditure may be carried forward.

(c) Preliminary Expenditure in connection with a new Business.

Heavy preliminary expenditure may be incurred in connection with the commencement of a business, or the institution of a new department, before it can reach a revenue-earning stage. Such expenditure may take the form of rent, rates, salaries, wages and general charges; and in order to avoid unduly burdening the Profit and Loss Account of the first period, it may properly be carried forward, and written off over a period of three or five years. In such a case the auditor should ascertain that all current expenditure incurred after the revenue-earning stage has been reached is charged to the Profit and Loss Account.

§ 5.—The Valuation of Assets.

It may be convenient here to indicate the general principles which should be applied to the valuation of assets in a Balance Sheet. The legal aspect of the subject as affecting limited companies will be dealt with in Chapter VIII.

(a) Fixed Assets.

Fixed Assets are those of a permanent nature, by means of which the business is carried on, and which are held for the purpose of earning income, and not for the purpose of sale, *e.g.*, land, buildings, plant and machinery, etc.

Such assets should be shown in the Balance Sheet at cost and the total of the provisions made to date for

depreciation shown as a deduction therefrom. Depreciation must be calculated on such a basis as will spread the expenditure equitably over the effective lifetime of the assets, so that the Profit and Loss Account of each accounting period may be charged with its proper proportion of the cost. It is not necessary to take into account the market value of fixed assets, even when this is subject to considerable fluctuation, since these assets are not acquired for the purpose of sale, and their current market value is of no significance in estimating the amount of the unexpired capital outlay. In the event of a forced realisation of fixed assets, heavy losses would probably ensue, but it would not be reasonable to anticipate such losses before arriving at the current profits of the business.

(b) Current Assets.

Current assets are those in which the business deals, and which are acquired for the purpose of sale, and the subsequent stages of their conversion into cash, *e.g.*, stock, book debts, cash.

The valuation of current assets should be at cost or market price, whichever is the lower at the date of the Balance Sheet. The object of the business being to convert current assets into cash, and make a profit on dealing in them, it becomes a point of the utmost importance that the valuation placed on these assets at the date of the Balance Sheet shall be such that any loss sustained in connection therewith may be taken into account.

(c) Wasting Assets.

Wasting assets are those of a fixed nature which are gradually consumed or exhausted in the process of earning income, *e.g.*, a mine, cemetery, etc.

It will be seen that wasting assets are in effect a sub-division of fixed assets, but include only such as decrease in value through the operation of being worked, and therefore are not subject to depreciation through wear and tear.

The question as to the value at which wasting assets should appear in the Balance Sheet is particularly important as affecting limited companies, and involves legal considerations. The subject is fully treated in Chapter VIII.

From a general point of view, it may be remarked here that in order to replace the exhausted capital out of revenue it is necessary to reduce the book value of the wasting asset to the extent of the estimated amount by which it has diminished in value.

Owing, however, to the difficulty experienced, in many cases, of ascertaining the loss occasioned by the wasting of the asset, it is common to find that provision is made therefor by way of a Depreciation Reserve, the asset remaining in the books and hence in the Balance Sheet at its original value.

§ 6.—Depreciation.

(a) General Considerations.

One of the most important points which an auditor has to consider is whether sufficient provision has been made in the accounts for depreciation.

Depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a given period. If an asset has been acquired for the purpose of being utilised to earn income, and in the course of such process it becomes worn out or obsolete, such expired capital outlay is a loss which should be set off against the income derived from working the asset, before the balance of divisible

profit can be ascertained. If this is not done, the Profit and Loss Account will not show the correct profit for the period, and the Balance Sheet cannot be said to represent the true and correct view of the state of the affairs of the business, inasmuch as the assets will remain at their original value, notwithstanding the fact that depreciation has taken place.

Where objection is taken by clients to the proper provision for depreciation, and the auditor advances theoretical arguments in support of his view, these do not always receive sufficient consideration, owing to the fact that the practical bearing of the question of depreciation upon the financial position of the business is not sufficiently emphasised. It cannot be too strongly pointed out that if the whole of the profits of a business are withdrawn without providing for the loss arising through depreciation, no moneys will be accumulated out of revenue during the life of the asset for the purpose of replacement. When such replacement becomes necessary, fresh capital will have to be provided for the purpose. Many cases have arisen where, owing to depreciation having been ignored, businesses have been obliged to go into liquidation on the exhaustion of their capital assets, solely through the impossibility of raising fresh capital for the purpose of renewal.

In this connection it may be remarked that where large sums will be required at some subsequent period for renewal of assets, it is advisable that the moneys provided out of revenue for replacements should be invested outside the business, in order that they may readily be available. If the amount so set aside is left in the business, it will in due course form part of the working capital, and may be locked up in

stock or other assets which may not be capable of ready realisation when it is necessary for the replacement to be made.

Before the auditor can satisfy himself that the provision made for depreciation is adequate, he must have some knowledge of the considerations which are necessary to determine the rate of depreciation in connection with any particular class of asset.

Depreciation may be said to arise from two causes —Internal and External. Internal depreciation is that arising from the operation of any cause natural to, or inherent in, the asset itself, *e.g.*, wear and tear in the case of plant and machinery. External depreciation is that arising from the operation of forces outside the asset itself, *e.g.*, obsolescence in the case of plant; effluxion of time in the case of a lease.

In order to fix the rate of depreciation, the average life of the asset must be determined, and before this can be done the various forms of depreciation to which it may be subject should be considered. It is usually possible, given some knowledge and experience of the business concerned, to estimate the rate of internal depreciation, such as wear and tear, with reasonable accuracy. The loss occasioned by effluxion of time can be calculated exactly, but other forms of external depreciation are often so variable that the amount cannot be estimated accurately, and consequently complete provision is not usually made until the actual loss occasioned thereby has arisen.

The term "depreciation" should not be confused with "fluctuation," which connotes *temporary* change in value, quite distinct from depreciation of a permanent character.

Where the auditor is of opinion that insufficient provision has been made for depreciation, and he is

unable to induce his clients to adopt his point of view, he *must* deal with the matter in his report. The contention is frequently made that depreciation is an appropriation of profits, and not a charge thereto, and that consequently if no profits have been made, or a loss on trading has been incurred, no provision for depreciation can be made. The fallacy of this argument is apparent when it is seen that depreciation is a fact which exists, irrespective of the results of the business, and as such should be recorded in the books of account.

In considering the basis of depreciation, it should be remembered that in the course of years, conditions may materially alter, and thus affect the accuracy of the original calculations. It is therefore advisable that the rates should be reconsidered from time to time.

(b) The principal methods of providing for Depreciation as affecting different classes of Assets.

The following are the principal methods of providing for depreciation, where it is desired that the amount set aside should be accumulated *in the business* :—

THE FIXED INSTALMENT SYSTEM, OR "STRAIGHT LINE" METHOD whereby a *fixed* rate per cent. on the original cost of the asset is written off each year, so as to reduce the asset to nil or break-up value at the end of its life, repairs and small renewals being charged to revenue.

THE REDUCING INSTALMENT SYSTEM, whereby a fixed rate per cent. on the *diminishing* value of the asset is written off each year, so as to reduce the asset to break-up value at the end of its life, repairs and small renewals being charged to revenue.

The Annuity System, whereby the asset is regarded as earning a certain rate of interest, and such fixed amount is written off each year as, after debiting the asset account with interest at the fixed rate per cent. upon the diminishing value, will reduce the asset to nil at the end of its life.

Where it is desirable to accumulate moneys *outside the business*, the following are the principal methods utilised :—

The Depreciation Fund System whereby an equal amount is debited to the Profit and Loss Account each year, and credited to a Depreciation Fund Account, and an equivalent amount of cash is *invested outside the business* in gilt-edged securities, and allowed to accumulate at compound interest, so as to produce the required amount on the completion of a given number of years.

The Insurance Policy System whereby an Endowment Policy is taken out for the life of the asset, so as to produce the amount required at the end of the particular period.

In cases where the nature of the asset renders it difficult to provide for depreciation on a mathematical basis, Re-valuation should be resorted to. In this case, the asset will be revalued each year and the loss disclosed on book value written off to revenue.

The Depletion Unit System, applicable to wasting assets such as mines and quarries, whereby such a sum is set aside each year out of profits as represents the expired capital outlay, on the basis of a comparison of the amount of the produce extracted during the period with the estimated total contents of the mine, etc.

THE MACHINE HOUR SYSTEM. Under this system, the estimated total number of working hours of a machine during the whole of its effective life is divided into the cost of the machine to arrive at an hourly rate of depreciation. The Profit and Loss Account of each period is then charged with depreciation, calculated at the hourly rate, for the number of hours during which the machine has been worked during the period.

These various methods are fully dealt with and illustrated by means of examples in Chapter IV of the authors' volume on *Book-keeping and Accounts*, and it is now proposed to discuss the application thereof as affecting different classes of assets.

The recommendations of the Council of the Institute of Chartered Accountants on this subject of Depreciation are reproduced hereunder.

Fixed assets, whatever be their nature or type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purpose of sale, in the ordinary course of business. The amount at which they are shown in the balance sheet does not purport to be their realisable value or their replacement value, but is normally an historical record of their cost less amounts provided in respect of depreciation, amortisation or depletion.

Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an intregral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned.

The assessment of depreciation involves the consideration of three factors: the cost of the asset, which is known, the probable value realisable on ultimate disposal, which can generally be estimated only within fairly wide limits, and the length of time during which the asset will be commercially useful to the undertaking. In most cases, this last factor is not susceptible of precise calculation. Provisions for depreciation are therefore in most cases matters of estimation, based upon the available experience and knowledge, rather than of accurate determination. They require adjustments from time to time in the light of changes in experience and knowledge, including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset.

There are several methods of apportioning depreciation as between the several financial periods which constitute the anticipated useful life of the asset. Those most commonly employed in industrial and commercial concerns in this country are the straight-line method and the reducing balance method.

Subject to any periodic adjustment which may be necessary, the straight-line method (computed by providing each year a fixed proportion of the cost of the asset) spreads the provision equally over the period of anticipated use. It is used almost universally in the United States of America and Canada and to a large extent in this country. Though other methods may be appropriate in the case of some classes of assets, the balance of informed opinion now favours the straight-line method as being the most suitable for general application.

The reducing balance method which spreads the provision by annual instalments of diminishing amount computed by taking a fixed percentage of the book value of the assets as reduced by previous provisions, is also largely used in this country. It involves relatively heavy charges in the earlier years of the life of an asset and relatively light charges in the later years. In order to provide depreciation under this method within any given period, the percentage applied needs to be from two to three times that applied under the straight-line method. This is a fact not generally realised, the consequence being that rates of depreciation fixed on this basis may tend to be inadequate.

A third method, known as the sinking fund method, which endeavours to take account of anticipated income from funds set aside for depreciation purposes, is not used to any great extent in industrial and commercial concerns, though in public utility undertakings, where special considerations arise, it is frequently met. Under this method, fixed annual instalments are provided and set aside, which with compound interest, will accumulate to the cost of the asset by the end of its useful life. Where the amounts set aside are invested outside the business, the validity of the calculations depend upon the realisation of the anticipated net rate of interest, and each change in tax rates or interest yield involves recalculation. Where the amounts are retained as additional working capital, the effect is to make a growing charge in the periodic accounts for depreciation, because the fixed periodic instalment has to be supplemented in each period by an amount equivalent to interest on past provisions. Experience shows that, with the uncertainties inescapable in industrial and commercial enterprises, it is not prudent to place reliance upon the accrual of additional earnings to the extent required.

A fourth method, also not commonly used in industrial and commercial concerns, is the renewals reserve method, under which round sums, not necessarily computed by reference to the useful lives of the assets, and sometimes determined largely by the results of the year's trading, are provided and set aside as general provisions towards meeting the cost of future renewals. This method does not accord with a strict view of depreciation and may distort the annual charges to revenue.

The different natures of assets involve consideration in deciding on the method of depreciation appropriate in each case. Unless the methods adopted are applied consistently the usefulness of periodic accounts for the purpose of comparison of one period with another may be vitiated.

Whatever be the method adopted, the periodical revision of depreciation rates and the ascertainment of the residue of cost which has not been covered by depreciation provisions made up to any given date are greatly facilitated by, and often impracticable without, the maintenance of fixed asset registers showing the cost of each asset, the provisions for depreciation made thereon and the basis on which these have been calculated.

RECOMMENDATION.

It is therefore recommended that—

1.—Provisions for depreciation, amortisation and depletion of fixed assets should be applied on consistent bases from one period to another. If additional provisions prove to be necessary, they should be stated separately in

the profit and loss account. Where practicable, fixed assets *in existence at the balance sheet date* should normally be shown in the balance sheet at cost and the aggregate of the provisions for depreciation, amortisation and depletion should appear as deductions therefrom (see Recommendation VIII). The extent to which these provisions are being kept liquid will then be ascertainable from the balance sheet as a whole.

2.—Such provisions should be computed on the basis mentioned below as being appropriate to the particular class of asset concerned:—

(a) *Goodwill and Freehold Land.*

Depreciation does not arise through use in the business, except in the case of freehold land acquired for purposes such as are referred to in (d) below. Amounts set aside to provide for diminution in value do not constitute a normal charge against revenue and should be shown separately in the profit and loss account.

(b) *Freehold Buildings, Plant and Machinery, Tools and Equipment, Ships, Transport Vehicles and similar assets which are subject to depreciation by reason of their employment in the business.*

Provision for depreciation should, in general, be computed on the straight-line method. Assets of very short effective life, such as loose tools, jigs and patterns, may, however, frequently be dealt with more satisfactorily by other methods such as re-valuation, which in no case should exceed cost.

(c) *Leaseholds, Patents and other assets which become exhausted by the effluxion of time.*

Provision for amortisation should be made on the straight-line basis, including, in the case of leaseholds, allowance for the estimated cost of dilapidations at the end of the lease or useful life of the asset if shorter. If a leasehold redemption policy is effected with an insurance company, the charge of the annual premiums to profit and loss account provides a satisfactory method of amortisation if supplemented in respect of dilapidations.

(d) *Mines, Oil Wells, Quarries and similar assets of a wasting character which are consumed in the form of basic raw material or where the output is sold as such.*

Provision for depreciation and depletion should be made according to the estimated exhaustion of the asset concerned. In the case of an undertaking formed for the purpose of exploiting this particular class of asset, if the practice is to make no provision this should be made clear in the accounts so that shareholders may realise that dividends are, in part, a return of capital.

3.—Where a method different from that recommended has hitherto been followed and it is not considered practicable or desirable to make a change in the case of assets already in use, it is suggested that the methods recommended should be followed in cases of assets subsequently acquired.

4.—Details of all fixed assets should be kept (preferably in registers specially maintained) to show the cost of each asset, the provisions made for its depreciation and the basis of the provisions made.

5.—Amounts set aside out of profits for obsolescence which cannot be foreseen, or for a possible increase in the cost of replacement are matters of financial prudence. Neither can be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts.

(1) *Freehold Land.*

It has been said that freehold land does not depreciate, but it is subject to considerable fluctuation in value, which may be either of a temporary or permanent character. If the land has permanently fallen in value below cost, depreciation has taken place. It is, however, not usual to make provision for such loss, or to record it in the accounts until the property is realised.

(2) *Freehold Buildings.*

The amount of depreciation which should be provided in respect of freehold buildings will depend on the age of the buildings, and the nature of the business for which they are utilised. Repairs should in all cases be charged to revenue, and where the property is maintained in a good state of repair, the period of its life will be materially extended. If the building is an old one, it may become at some future time necessary to rebuild. Apart from this consideration, under normal circumstances the rate of depreciation should be taken at from 1 to 3 per cent. per annum, calculated on the cost, and it is advisable that the method adopted should be either the *Depreciation Fund* or the *Insurance Policy* system, since in this way moneys will be readily available for rebuilding purposes. Otherwise the *Annuity* system should be used, since, in the case of an asset possessing a long life, the question of the adjustment of interest becomes important, owing to the fact that the moneys representing depreciation are left in the business.

Generally the item Freehold Land and Buildings is shown in one sum, and the values attaching to the land and buildings respectively are not differentiated. In such cases, the value of the buildings for the purpose of depreciation must be estimated.

(3) *Leasehold Land and Buildings.*

Where *leasehold* land is bought and buildings are erected thereon, provision should be made to replace the cost of the land and buildings at the expiration of the lease, and should additional buildings be erected, further provision must be made in respect thereof.

The premium paid for the acquisition of the lease may be regarded as a capitalisation of the difference between the outgoings payable under the lease in the shape of ground rent, etc., and the annual value of the property. If, therefore, only the actual outgoings are charged against the Profit and Loss Account, the business will not be debited with the actual rental value of the premises occupied. The depreciation of leasehold property, therefore, may be regarded as a form of rent.

Where the value of the lease is small, and the term unexpired does not exceed, say, seven years, the simplest method of providing depreciation is by the *Fixed Instalment System*. Where the lease is a longer one, but it is not regarded as essential that the amount set aside should be invested outside the business, the *Annuity* system should be adopted. Under this system the operation of charging interest on the diminishing value of the asset has the effect of increasing the net charge to revenue each year, to the extent of interest on the net amount set aside and accumulated in the business. The amount so set aside will be utilised as working capital, and should be the means of earning additional profit.

Where the value of the leasehold property is considerable, and the cost of renewing the lease or acquiring fresh premises will be heavy, provision for

depreciation should be made by the *Depreciation Fund* system, or by the method of taking out an *Endowment Policy* for the value of the lease.

Where the former system is adopted, the auditor should check the calculations necessary to determine the annual amount to be set aside, and should see that the interest arising on the investments is regularly re-invested. Where the investments representing the Depreciation Fund have permanently depreciated in value, additional provision should be made to cover the loss occasioned thereby.

The system of taking out an Endowment Insurance Policy for the value of the lease is becoming increasingly popular, as it avoids the trouble involved in continually investing moneys, and if the policy is taken out with a good company, the precise amount required is ensured without any risk of loss on investments. The auditor should see that an amount equivalent to the annual premiums is charged against Profit and Loss, and credited to the Redemption Account, the premiums paid being debited to a Policy Account, and treated as an asset. It is incorrect to charge the premium direct to Profit and Loss, as, although this has the same effect on the Profit and Loss Account, the policy will not appear in the Balance Sheet as an asset, nor will any Redemption Fund appear against the lease.

The various insurance companies adopt different methods of calculating the surrender value of these policies, one method being to take the total of the premiums paid, less the first premium, plus 2 per cent. per annum compound interest. In some cases the Policy Account is adjusted annually by debiting the interest accrued, and crediting the Redemption Account,

for which purpose it is permissible to treat the first premium as an asset. The amount of interest so allowed for surrender value purposes is less than the rate of interest that will be realised when the policy matures, and a profit will therefore ultimately appear on the Policy Account. Such profit should be transferred to the Redemption Account, which in that way will be brought up to the value of the lease, and can be utilised to write off the old Lease Account. In other cases no account is taken of the accruing interest, and consequently the profit on the termination of the policy will be so much greater. In no event should the interest accrued be credited to Profit and Loss.

On the termination of a lease, a claim for dilapidations usually arises, and in some cases this involves a considerable sum. It is desirable that provision should be made to cover this liability during the life of the lease, and it is most convenient to do this by adding an estimated amount for dilapidations to the cost of the lease before computing the annual charge for depreciation. Another method is to deduct one or more years from the term of the lease; but where the lease is a long one, and the annual charge for depreciation consequently small, this may not be sufficient.

All repairs expended on the property during the period of the lease should be charged to revenue, and where, owing to the age of the building, it may be necessary to rebuild before the termination of the lease, additional provision for depreciation should be made accordingly.

(4) *Fixed Plant and Machinery.*

Depreciation arises on fixed plant and machinery by reason of wear and tear and obsolescence. The

effect of wear and tear on the life of the asset should be capable of reasonable estimation, having regard to the state of repair in which it is maintained; machinery which is properly kept up lasting very much longer than where repairs are neglected. Repairs and small renewals should be charged to revenue.

Theoretically, the most correct way of providing for depreciation on this asset is by the *Fixed Instalment* system or "*Straight-Line*" method, since only by this method can the plant be written down to nil at the expiration of its estimated life; and when this method is adopted a special book should be kept, subsidiary to the Ledger Account, in which to record the details of all expenditure on the particular class of Plant and Machinery concerned. This will enable a record to be kept of each year's additions, upon which separate depreciation calculations will be necessary. The depreciation credited to the asset account in such a case will really consist of a number of separate depreciation calculations made in respect of the original purchase and of each year's additions until they are individually written off.

In many cases, however, it will not be necessary to reduce the book value of the plant to nil, as the asset will possess some scrap value; in such circumstances, the depreciation calculations must be adjusted accordingly. It is, however, very usual to depreciate plant on the *Reducing Instalment* system, additions being debited to the asset account, and a fixed rate written off the reducing balance. In fixing such rate, it must be remembered that a considerably higher rate should be taken than if the calculation were made on the Fixed Instalment system; *e.g.*, on a Capital sum of £5,000, 5 per cent. per annum on

the Fixed Instalment system will reduce the asset to nil at the end of 20 years; whereas on the Reducing Instalment system the balance left would be £1,792.

An argument often advanced in favour of the Reducing Instalment system is that while the amount of depreciation tends to decrease, expenditure in the shape of repairs tends to increase, and consequently the annual total charge for maintenance is more regular. This argument, however, is based on the quite unjustifiable assumption that the annual reduction in the charge for depreciation will equal, if only approximately, the increase in the cost of repairs. Fluctuating charges to revenue, except by a fortunate accident, are bound to arise. Under the Fixed Instalment system the amount of depreciation remains the same, although repairs tend to increase, but this disadvantage may easily be overcome by estimating the total cost of repairs to be incurred during the lifetime of a machine and charging an equal portion thereof to revenue each year, a Provision for Repairs Account being credited. Where this is done, actual repairs incurred will be charged against the provision, and the total charge to revenue for repairs and depreciation thus equated.

It is interesting to note that in *Edwards* v. *Saunton Hotel Co. Ltd.* (1942, T.R. 359), the Court directed that for the purpose of ascertaining the profit on which a director's remuneration should be calculated, depreciation on fixed assets should be computed on the *fixed* instalment system, on the ground that if the reducing instalment system were used there would be a disproportionate charge against profit in the early years of the life of the assets.

Where the plant can readily be divided into various categories, some of which may vary as to life or risk of obsolescence, appropriate rates of depreciation for each class should be utilised, otherwise an equated rate must be taken.

Owing to the necessity of renewing the plant from time to time, there is generally no advantage in utilising the Depreciation Fund system, under which specific investment is made outside the business; but where the plant is of a heavy nature, which will require to be renewed *in toto* at the end of a lengthy period, this system should be adopted; and also in cases of fixed plant on leasehold works where the plant will pass with the lease.

The risk of obsolescence is difficult to estimate for the purpose of depreciation, and sometimes no account is taken thereof until the plant is actually superseded, when the loss may be written off over a period of years. In certain trades, however, such as the electrical trade, the motor trade, and others, where the possibility of obsolescence is considerable, allowance should be made therefor, and the rate of depreciation correspondingly increased; but as it is not always possible to estimate this risk with any degree of certainty, the asset should be subjected to periodical valuation, and adjustment made accordingly.

The risk of obsolescence is much greater under modern circumstances of competition and rapidly changing conditions, and unless ample provision is made for keeping plants up-to-date the earning capacity of the business may be severely diminished.

Machinery purchased under a hire-purchase agreement, or an agreement to pay by instalments, should be depreciated on the original cash value of the machinery, and not on the actual instalments paid.

(5) *Loose Plant and Tools.*

Depreciation of assets of this nature cannot be provided for satisfactorily by way of a percentage; the soundest method is by *revaluation,* especially in the case of engineering concerns, where such assets may be manufactured on the premises.

(6) *Furniture.*

Wear and tear of furniture should be provided for by depreciation on the *Reducing Instalment* system, at the rate of from 2½ to 12½ per cent. per annum, according to circumstances, repairs being charged to revenue, and renewals to the asset account.

(7) *Fixtures and Fittings.*

Depreciation on fixtures and fittings should be provided for in the same way as for furniture, but where the fixtures are on leasehold premises, and pass to the landlord at the expiration of the lease, provision should be made on the same basis as for the lease. In estimating the rate of depreciation, it should be remembered that whereas furniture can be removed, and thus will always possess some value, any value attaching to fixtures and fittings is usually irrecoverable on removal from the premises.

(8) *Patents.*

Patents suffer depreciation from effluxion of time, since a patent is only granted for a period of 16 years, though it may be subject to extension in certain cases. It is desirable, therefore, that the value of the patent should be written off over a period not longer than its official life, although in many cases a residual value remains in the shape of goodwill, built up during the continuance of the patent. Sometimes the Master

Patent is so protected by subsidiary patents that the asset remains of considerable value.

Other causes of depreciation affecting patents are obsolescence, the impracticability of working the patent at a profit, or failure to induce the public to buy the patented article. It by no means follows, therefore, that a patent remains of value during the whole of its life, and consequently revaluation in such cases should be resorted to. In no case should the value be written up, even though it prove to be much in excess of the cost price.

Fees incurred in taking out the patent are of a capital nature, but renewal fees for maintaining the patent must be charged to revenue, and not debited to the Patent Account.

It is preferable to adopt the *Fixed Instalment* system when it is desired to write off the whole cost of the patent over a term of years.

(9) *Copyrights.*

Similar considerations apply to copyrights as to patents, except that the term of copyright is considerably longer, being, with certain exceptions, the life of the author and a period of fifty years after his death. As the vast majority of copyrights do not retain any value during the greater part of their life, depreciation cannot be based on that period, and provision by way of *revaluation* of each copyright is the only really satisfactory method. Further remarks on this subject will be found in Chapter V, § 7 (7) and Chapter XII, § 23.

(10) *Horses.*

Horses depreciate through age, and according to the manner in which they are worked. Any rate of

depreciation that may be taken must necessarily be in the nature of an estimate, and it is preferable to work on a basis of *revaluation.* In any event, revaluation should take place not less than once every five years.

(11) *Motor Vehicles.*

These are usually depreciated by either the *Reducing Instalment* or the *Fixed Instalment Systems.* All repairs and running expenses should, of course, be charged to revenue.

(12) *Goodwill.*

The question is frequently discussed as to whether goodwill suffers depreciation which requires to be dealt with in the same manner as depreciation on other fixed assets. There can be no doubt that the value of the goodwill of a business may be less than the price at which it was purchased, owing to alteration in trade conditions, or to different management. The value of goodwill is dependent on profits, and if profits are not maintained, such value must necessarily fall.

Goodwill, however, is by its very nature an intangible asset, and if the amount at which it stands in the books is shown separately on the Balance Sheet, it is apparent that a portion of the capital of the business is represented by this asset, which must be in any event of a hypothetical value.

Goodwill, therefore, is not consumed or exhausted in the process of earning income; it is not subject to wear and tear, or to obsolescence; it does not suffer depreciation as a necessary consequence of carrying on business; and it does not require to be renewed. Its value tends to increase when profits increase, and to fall when profits fall. At the period when it might be

considered most desirable to write down the goodwill, the profits earned may not admit of this treatment. When goodwill is written down, it is written down in periods of good profits, and as a result a secret reserve may be formed.

So long, therefore, as the goodwill is not written up, but remains in the Balance Sheet at cost or under, the auditor need not concern himself with any fluctuation in its value.

§ 7.—Repairs and Renewals.

In discussing the question of depreciation, it has been stated that repairs and small renewals should in all cases be charged against revenue, and the auditor should ascertain whether this has been done. The distinction between small renewals, which should be charged to revenue, and replacements which can be treated as additions to capital, provided the rate of depreciation has been sufficient, is sometimes difficult to define. It is advisable for the auditor to examine all amounts debited to the asset account, and, by selecting certain items for enquiry, to satisfy himself that the treatment is a proper one.

The practice of debiting all expenditure on the asset, whether in the shape of repairs, renewals, or replacements, to the asset account, and relying upon a heavier rate of depreciation to adjust matters, is very undesirable, since it tends to conceal the real cost of maintenance, and may easily result in expenditure being improperly capitalised.

Where the expenditure on repairs is of a variable nature and considerable in amount, the estimated annual average charge under this heading may be debited to revenue, and credited to a Provision for

Maintenance Account, the actual repairs in each year being debited to this account, the balance of which should be carried forward, and separately stated in the Balance Sheet.

If such balance is a debit balance, there is no reason why it should not be carried forward, so long as it is likely to be recouped by subsequent instalments; but the auditor should satisfy himself on this point, since the fact of a debit balance being created may be due to the inadequacy of the annual charge, which in such cases should be increased. In any event, the amount of the annual charge will require to be carefully watched, and adjusted from time to time.

§ 8.—Reserves and Provisions.

Reserves and provisions are defined by the Companies Act, 1947, as follows :—

(*a*) The expression "provision" shall mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.

(*b*) The expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.

(*c*) The expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss

> account, and the expression "revenue reserve" shall mean any reserve other than a capital reserve.

Where a provision is, in the opinion of the directors of the company, in excess of that which is reasonably necessary for the purpose, the excess must be treated as a reserve and not as a provision.

Although these requirements of the Companies Act are applicable only to limited companies, it is most desirable, to avoid confusion, that the same meanings should be given to these terms in the accounts of partnerships and sole traders.

It will thus be seen that the term "reserve" should be used to describe amounts set aside out of profits and other surpluses which are not designed to meet any liability or contingency or diminution in value of assets known to exist at the date of the Balance Sheet. Revenue reserves are available for distribution as dividend, but capital reserves are not. The term "provision" should be used to describe amounts set aside out of profits to meet specific requirements the amounts whereof can be estimated closely, and specific commitments, contingencies and diminutions in values of assets existing at the date of the Balance Sheet where the amounts involved cannot be determined with substantial accuracy.

(a) Reserves.

It is not the duty of the auditor to concern himself with the adequacy or otherwise of amounts transferred to reserve, since this is a matter of financial policy. Frequently, however, he may be called upon to advise as to the amount that should be carried to reserve, and as to whether it is preferable to retain it in the business, or to invest it specifically. Where additional working

capital may be usefully and profitably employed in the business, it is sound financial policy to leave such profits in the business, since the amount so utilised will probably earn a far higher return than if it were invested in marketable securities. Where, however, it is desired to reserve more than can be profitably utilised in the business, a specific investment in securities should be made, to the extent of the excess amount so set aside. In this manner realisable assets can be utilised at any moment, should there be a sudden call upon the business. A reserve so invested is therefore a source of considerable strength. The fact, however, that the reserve is not invested in this manner, but is retained in the business, is not by any means a sign of weakness, since it may imply that the business is progressing, and consequently requires further working capital. At the same time the existence of such a reserve depends entirely upon the values placed on the assets, and if such values are excessive, owing to the omission of proper provision for depreciation, or from other causes, the reserve may only be a nominal one, or may be considerably smaller in fact than the figure at which it appears in the Balance Sheet.

Where a reserve is invested outside the business, it is called a *Reserve Fund.* It is often found in practice that this term is applied to reserves not represented by specific investments outside the business. In order to avoid misconception, it is preferable to use the term Reserve Account rather than Reserve Fund, where the reserve is not represented by specific investments outside the business, and this view has been endorsed by the Council of the Institute of Chartered Accountants in England and Wales in a memorandum published in October, 1943.

(b) Provisions.

A provision is made where a loss is anticipated, but the amount thereof being unascertained, it cannot be finally dealt with. As, however, the loss will have been incurred before the date of the Balance Sheet, the Profit and Loss Account should be debited accordingly, a Provision Account being credited.

Such provisions may be made to provide for losses likely to be sustained on the realisation of certain assets, or for accruing liabilities, the precise amount of which is not known, and which will not result in the acquisition of corresponding assets.

Instances of the former class are provisions for bad debts, discounts, etc., and it is the auditor's duty to satisfy himself that all estimated losses have either been written off or provided for in this manner.

The following are instances of unascertained liabilities in respect of which provisions will be made: loss resulting from a fire not fully covered by insurance; loss on bills discounted likely to be dishonoured; costs or damages under an action pending; claims not admitted. Such provisions are sometimes recorded under the heading of *Suspense Accounts*. The auditor should ascertain that due provision has been made for all contingencies of this nature of which he is aware.

(1) *Provision for Bad Debts.*

The question of bad and doubtful debts from the auditor's point of view has been fully dealt with in Chapter III, § 9 (*d*). Having ascertained in the manner there described what provision he considers should be made under this heading, the auditor should check the provision for Bad Debts Account in the Impersonal Ledger, and see that the necessary entries have been made.

Frequently the Bad Debt Account and the provision for Bad Debts Account are combined, the actual bad debts written off being debited against the provision brought forward from the previous year, and a credit balance carried down equivalent to the extent of the new provision that is necessary. The difference on the account will then represent the amount to be debited to Profit and Loss, being composed of the actual bad debts written off after the adjustment of the opening and closing provisions, and so representing the full charge for bad debts for the year. It is sometimes preferred, however, to show the actual bad debts written off separately in the Profit and Loss Account, apart from the adjustment of the provision.

It has been pointed out that it is not the duty of the auditor, as auditor, to make the provisions he considers to be necessary, neither has he power to do so unless instructed by his client, in which case he acts in the capacity of accountant. Where the provisions made are, in his opinion, insufficient, and he cannot persuade his client to increase them, he must deal with the matter in his report.

(2) *Provisions for Discounts.*

The necessity of providing for cash discount on outstanding debtors, and the anticipation of cash discount in respect of outstanding creditors, is a matter of opinion; but where the principle has once been adopted, the auditor should see that it is consistently carried out. The argument in favour of such a provision is that it is desirable that the book debts should appear in the Balance Sheet at the amount which it is expected they will ultimately realise, and that as the proportion upon which cash discount will

probably be allowed can be ascertained from previous experience, this should be taken into account.

The argument against the necessity for such provision is that as cash discount is an allowance made in consideration of the debtor paying his account within a given term of credit, the liability to allow such discount is conditional, and does not accrue until the debtor pays. Moreover, as the discount is granted for the purpose of inducing the debtors to pay their accounts as soon as possible, it may be regarded as an expense attendant thereon. The more rapidly the debts can be realised, the less will be the working capital required, and the more frequently can that capital be turned over in the course of the trading period. From this point of view, therefore, it may very well be argued that the expense of discount should be charged against the period which receives the use of the money.

The auditor, therefore, can point out the arguments in favour of such a provision, but it cannot be regarded as essential, and the omission to do so cannot be said to affect materially the accuracy of the Balance Sheet.

The amount of the provision necessary will be calculated either on each individual debt, or, more usually, by way of percentage on the outstanding *good* debtors, the rate of which will be based on the discount allowed in relation to the turnover of previous years.

The anticipation of discount in respect of outstanding creditors should not be permitted, unless provision is made against discount on outstanding debtors. Similar principles will apply as to its calculation.

(3) *Provision for Depreciation of Investments.*

Where a considerable number of investments is held, and the market value thereof at the date of the

Balance Sheet is less than the book value, it is advisable to provide for the depreciation that has occurred. The most convenient method of doing this is to create a Provision for Depreciation of Investments Account, by debiting Profit and Loss Account, and crediting the Provision Account with the difference between the total market value of the investments and their book value.

If this method is adopted, it will be unnecessary to amend the book value of each investment on the occasion of each Balance Sheet, the Provision Account being adjusted from time to time according to circumstances. In the event of any loss arising on realisation, this will be debited to the Provision Account instead of to Profit and Loss Account. In the Balance Sheet the Provision Account should be deducted from the Investments.

Where no provision is made and the depreciation is considerable, the auditor should refer to the matter in his report.

(4) *Insurance.*

It is customary in some businesses, where the amount of insurance is considerable, for a portion of the risk to be undertaken by the business itself, either in respect of fire, marine, or employers' liability. Where this is done, an amount equivalent to the premium which would have been paid had the insurance been effected outside, should be credited to an Insurance (Own Risks) Account, which should be allowed to accumulate, any losses arising thereunder being debited thereto. Strictly speaking, such accumulated premiums should be invested outside the business, so as to be easily available in the event of loss arising, and in such

cases the Insurance Account is termed an Insurance Fund, and will be represented by specific investments. Where, however, transactions of this nature are not numerous, and the amount of the accumulated premiums is insignificant, specific investment thereof is not usually made.

The auditor should ascertain that proper provision has been made under this heading, and that no profit is taken in respect of such transactions until the amount of the accumulated premiums is considerably more than is sufficient to cover any probable loss.

This subject more particularly affects shipping companies, and will be discussed more fully in Chapter XII, § 28.

§ 9.—Contingent Liabilities.

The auditor should ascertain whether there are any transactions outstanding at the date of the Balance Sheet which may involve the payment of moneys at some subsequent date. Such outstandings are termed "Contingent Liabilities," and may be of two classes: the one involving a loss should the liability accrue, and the other the acquisition of an asset of corresponding value.

Where, in the event of the liability accruing, a loss would be incurred, it is sufficient for the amount of the contingent liability to be stated on the face of the Balance Sheet by way of a note, unless there is a definite probability that a loss will materialise, when specific provision should be made therefor. The most familiar instance is the contingent liability on bills receivable discounted. If at the date of the Balance Sheet any of the bills that have been discounted are outstanding, there will be a contingent liability in

respect thereof, since, if the acceptors do not meet the bills at maturity, the holders will have a right of recourse against the drawer or any prior indorser. As it may not be known at the date of the Balance Sheet whether all these bills will be met, a note of the amount of the contingent liability must be appended. Where, however, it is anticipated that any bills will be dishonoured, and that a loss will be subsequently incurred, provision should be made accordingly. In many cases, by the time the audit is completed several of the bills will have matured, and it will be only in respect of those still outstanding that the auditor should consider the advisability of a provision being made.

Other instances of contingent liabilities which might involve a loss, should they accrue, would be damages and costs in the case of an action pending, forward contracts, guarantees for third parties, and speculative transactions open on the Stock Exchange. The last-mentioned will be considered in Chapter XII, § 34.

In cases where, should a liability accrue, it will involve the acquisition of a corresponding asset, it is usual to make no reference thereto on the Balance Sheet. Instances of this are contingent liabilities under trade contracts, or under agreements for service, or for the erection of plant or buildings, though where the amount involved is considerable, it is advisable to note it. The contingent liability in respect of shares partly called up, held by way of investment, must be disclosed.

CHAPTER V

THE VERIFICATION OF ASSETS

§ 1.—General Considerations.

The most important duty of the auditor, apart from his examination of the books of account, is the verification of the assets appearing in the Balance Sheet. If the transactions have been correctly recorded in the books, evidence will appear therein of all the assets that have been acquired in the course of business; but it is not sufficient for the auditor to verify the correctness of the Balance Sheet as shown by the books—he must go further, and verify, by actual inspection or otherwise, the *existence* of the assets. The fact that there is an entry in the books recording the asset does not prove that the asset itself exists, even though the auditor may have vouched the accuracy of the entry. The entry only goes to prove that the asset ought to exist, and it is the duty of the auditor to satisfy himself that the asset actually does exist; and if his inspection or examination of evidence takes place after the date of the Balance Sheet, he must satisfy himself that the asset existed at the date of the Balance Sheet.

In the case, however, of those assets which continually change in the ordinary course of business, such as cash, bills receivable, and, in some cases, investments, an inspection should be made either at the close of business on the day of the Balance Sheet or as soon thereafter as possible. If transactions have occurred subsequent to the date of the Balance Sheet,

and prior to the date of examination, these must be vouched, in order to prove the existence of the asset at the date of the Balance Sheet. Where dealings are numerous, and delay has taken place, the difficulty of verifying in this manner is considerable.

One of the commonest forms of fraud is the misappropriation of cash or other assets of an easily negotiable character, and in verifying such assets the auditor should take every precaution, in order that he may not be deceived by any substitution of assets; *e.g.*, where there are several cash balances, the auditor should call for the production of all of them at the same time, since, if he examines them on different days, a portion of one balance may be utilised to make good a deficiency in another. In a similar manner, where there is a large number of investments, care must be taken to see that all are produced at the same time. It must be remembered that it is possible for negotiable assets to be fraudulently pledged. Unless, therefore, proper precautions are taken, the assets that have already been verified by the auditor may be utilised to free those that have been pledged, which, being thus released for the auditor's inspection, could be returned to the pledgee immediately afterwards. For this reason the auditor must take such precautions as will enable him to satisfy himself that all the assets he examines are free from any charge upon them which is not in order, and recorded in the books of the business.

Another form of fraud, which the verification of assets serves to guard against, is the improper inflation of values, or the creation in the books of the record of an asset which does not exist, or which in fact never has existed. The object of this form of manipulation is in most cases to increase the profits, and correspondingly

to increase the assets, thus making the position of the business, as shown by the Balance Sheet, appear stronger than it actually is. A common instance of this is the inflation of stock-in-trade, either by over-valuation or by the inclusion of fictitious items.

The verification of assets, therefore, should include not only the verification of their existence, but also of the values at which they appear in the books, as far as it is possible for the auditor to satisfy himself of this.

Misappropriation of assets, inflation of profits, and falsification of the Balance Sheet, may not be detected by the auditor if he is negligent in the performance of his duties in this connection, and he may find himself liable for heavy damages in consequence.

Documents of title deposited with bankers, stock-brokers, solicitors and others for safe custody, or for the purpose of reference or sale, should actually be inspected by the auditor where possible. In any case, he should obtain a certificate from the holder stating that the assets are held free from charge; and where he relies upon such certificate, he should state in his report that he has done so.

The verification of the different classes of assets common to most Balance Sheets will now be considered. Assets of a special nature affecting particular businesses will be dealt with in Chapter XII, devoted to the audits of different undertakings.

§ 2.—Land and Buildings.

(a) Freehold Property.

The title deeds should be examined by the auditor. He cannot, however, make himself responsible for the validity of the title; nor should he attempt

to verify it. That is the duty of the solicitor, and it is sufficient if the auditor ascertains that the title deeds appear to be genuine, and in order; that they refer to the property, the existence of which he desires to verify, and that the sequence of the various deeds composing the title appears to be complete. He should examine the last deed, and see that the property is duly conveyed to his clients or their trustees.

If the property has been mortgaged, the title deeds will be in the possession of the mortgagee or his solicitor, and a certificate should be obtained to that effect.

In the case of freehold ground rents, title deeds and counterparts of leases should be examined by the auditor, and it should be seen that the last ground rent has been duly received.

If the land has been registered under the Land Transfer Acts, a Land Registry Certificate will be issued, which the auditor should inspect. This certificate states that the land described therein is registered with an absolute, qualified, good leasehold, or possessory title (as the case may be). It may be in the possession of the owner of the property, or may be deposited at the Land Registry. New certificates are not made out on the transfer of registered land, but a note of the transfer is indorsed upon the certificate. Except in special cases, all documents of title are retained at the Registry.

Subject to any depreciation that may be necessary in respect of buildings, the freehold property should appear in the Balance Sheet at cost. It is not desirable to write up the item, even though the actual value of the land may have increased, but where this course is followed, the method adopted must be clearly

shown in the accounts. On the other hand, it is not usual to take account of any fall in the market value until realisation, when the loss can be accurately ascertained.

(b) Leasehold Property.

The lease and the assignment thereof (if any) should be inspected, and the auditor should ascertain that all conditions, the non-fulfilment of which might involve forfeiture of the lease, such as prompt payment of ground rent, maintenance of fire insurance, covenants as to repairs, etc., have been duly complied with.

Where leasehold property has been sub-let, the counterpart of the tenant's agreement should also be examined.

It should be seen that proper provision has been made for depreciation of leases.

§ 3.—Investments.

Where investments are numerous, the auditor should have produced to him a schedule showing the full title of each investment, the book value, and the market value thereof, as at the date of the Balance Sheet.

The whole of the investments should be produced at the same time, and where they are registered in the names of individuals, as trustees for a company or corporation, a deed of trust should be produced. Where no such deed is in existence, the auditor should obtain a letter from the parties, stating that they hold the investments on behalf of the company, free from any charge, and he should advise that a deed of trust be entered into. In all cases the auditor should see that the particulars of the investments correspond with those entered on the schedule, especially where different classes of stock or shares are issued by the same company.

Where the actual securities are not examined, but the auditor obtains a certificate from bankers or other parties, the certificate should state that the securities are held free of any charge or encumbrance, and, except where the certificate is given by one of the principal banks, the auditor should refer specially to the matter in his report and state the name of the person giving the certificate.

(a) Registered Stocks and Shares.

The term "registered" implies that the name of the holder has been entered in the register of the company, and that a certificate has been issued in his name. The certificate will be examined, and the auditor should see that it appears to be properly executed and sealed.

Where registered stock or shares have been sold prior to the date of the Balance Sheet, but delivery has not been effected at the date of the Balance Sheet, the certificate will not have been handed over, and should be produced, together with the broker's sold note; or if the certificate has been sent to the broker his receipt should be seen. If delivery has been effected, it should be seen that the proceeds of sale have been duly received.

Where part of a holding has been sold, and the certificate for the total holding has been delivered, but no new certificate has yet been issued, the auditor should call for the balance receipt, which is an interim certificate, issued for the balance of the shares held, until the new certificate can be prepared. Some companies do not issue these balance receipts but will certify the balance if called upon to do so. In other cases the transfer is indorsed on the back of the original certificate.

Where shares have been purchased and the transfer deed lodged with the company for the purpose of registration, but the new certificate has not been issued at the date of the audit, the auditor should ask to see the transfer receipt. This will state that a transfer has been lodged, transferring certain shares from one party to another, and will be *primâ facie* evidence of ownership. These transfer receipts are not always issued, but can be obtained if required.

In many cases, however, the balance or transfer receipts will be in the possession of the broker, through whom the sale or purchase was effected, pending collection of the new certificate. In such circumstances a certificate should be obtained from the broker to the effect that he holds such documents.

In the case of many American concerns, certificates are issued the title in which passes by delivery and indorsement on the back. Where the purchaser desires to be registered, his name must be inserted on the indorsement as transferee, and a new certificate will be issued to him on delivery of the old certificate properly indorsed. Where, however, it is not anticipated that the stock will be held for any length of time, it is not usual to fill in the names of the transferee, or to obtain a new certificate, and the old certificate endorsed by the transferor in blank will be sufficient evidence, if the name is a good market name or the signature is guaranteed,though it should be remembered that in this way the document of title becomes a bearer document until the name of the transferee is inserted.

(b) Inscribed Stocks.

No certificate is issued to the holder of this class of stock, but his name is inscribed in the register of

stock kept at the place of inscription which may be the Bank of England, the Crown Agents for the Colonies or one of the joint stock banks. British Government Stocks, such as Consols, War Loan, Conversion Loans, Annuities, etc., may be inscribed in this manner; also a large number of Colonial Issues, London County Council Stocks, and many Municipal Issues. No additions are now made to the register of British Government Inscribed Stocks, but when such stocks are sold the transferees are registered and receive stock certificates. In time, therefore, this form of holding will disappear so far as British Government Securities are concerned, although this will take many years, in view of the vast number of stockholders involved.

At the time of purchase of inscribed stock a stock receipt is issued, setting forth the nominal amount purchased and the consideration; but this receipt does not require to be delivered on the sale of the stock, and consequently possesses no value as a document of title. In order to verify the existence of stock at the date of the Balance Sheet, a form of certificate should be obtained from the Bank of England, or other place of inscription, which should be filled up with particulars of the stock, and the names of the persons to whom it is inscribed, and sent to the Bank for verification. If in order, the certificate will be returned duly signed on behalf of the Bank, and is evidence that so much stock was held on the day in question. This certificate does not require to be delivered on sale, and consequently a fresh certificate must be obtained on the occasion of each audit. The application for the certificate must be signed by one of the stockholders, and, in the case of certain stocks, a fee of 6d. on each

stock, with a minimum fee of 1s., must be paid. The certificate will be sent direct to the auditor, if instructions are so given, and it is advisable that this should be done, in order to prevent the possibility of any alteration in the figures. The certificate also states (in most forms) that no distringas or other restraint is recorded against the stocks in question.

(c) **Bonds to Bearer, and other Securities.**

The bonds should be examined, and it should be seen that the coupons for the next payment of interest are attached, as otherwise the bonds are not good delivery.

In the case of share warrants to bearer, where the dividends are not payable at fixed dates, coupons for dividends will not bear any printed date.

Where stock has only recently been issued, and all the instalments or calls have not been paid, definitive certificates or bonds will not as a rule be seen. The document of title will then consist of the letter of allotment, with bankers' receipts attached for the sums paid on application and allotment, calls or instalments. Where interim certificates or bonds have been issued, and the stock is only partly paid, the voucher for calls or instalments subsequently paid will usually take the form of indorsement on the document, which will continue to be held as evidence of title until it is ultimately exchanged for a definitive certificate or bond.

(d) **Tax Reserve Certificates.**

The certificates in hand should be inspected, it being seen that they are in the name of the client and not out of date. If the certificates are held by the clients' bankers for safe custody, a certificate should be obtained from the bank that they are so held.

Where certificates have been surrendered in payment of taxation since the date of the Balance Sheet but before the attendance of the auditor, the Inland Revenue receipts must be examined and the calculation of the interest claimed on surrender checked.

It is recommended that tax reserve certificates should be shown separately on the Balance Sheet and grouped with the current assets. The interest allowed on certificates surrendered in payment of taxation should be treated as interest received, and not as a reduction of the taxation charge in the accounts. It is inadvisable to take credit for interest accrued on certificates held at the date of the Balance Sheet, unless the certificates have been surrendered before the Balance Sheet is signed.

(e) Verification of Values.

Investments should appear in the Balance Sheet at cost or under, and brokers' bought notes will be sufficient evidence of the price paid. The necessity or advisability of providing for depreciation can only be considered in relation to the present value of the investments, and the auditor should therefore ascertain this as far as he is able to do so.

In the case of stocks and shares quoted on the Stock Exchange, the Official List published at the date of the Balance Sheet should be consulted and the middle price taken. Stocks and shares not officially quoted may nevertheless be quoted by financial papers, and if so, the mean of the various markings should be taken.

Where no quotation exists, considerable difficulty is sometimes experienced in arriving at a fair estimate of the value. Enquiries can be made of the secretary of the company concerned, as to the recent prices at

which shares have been transferred; but this is not necessarily a true criterion of the value, inasmuch as, where no free market exists, the purchase consideration does not always represent the actual value. In any case, such information is not sufficient, and the auditor should ascertain what dividends have been paid recently on the shares, and inspect a copy of the last audited Balance Sheet of the company concerned.

In the case of investments in subsidiary companies, special considerations may arise which are dealt with in Chapter IX.

Investments should not be written up except in special circumstances as in the case of changes in a partnership; but on a revaluation of all the investments a rise in the value of some may be set off against a fall in the value of others.

In the case of limited companies, the aggregate amounts respectively of the company's trade investments, quoted investments other than trade investments and unquoted investments other than trade investments must be shown under separate headings in the Balance Sheet. The heading showing the amount of the quoted investments other than trade investments must be sub-divided, where necessary, to distinguish the investments as respects which there has, and those as respects which there has not, been granted a quotation or permission to deal on a recognised Stock Exchange. It is also necessary to show on the Balance Sheet or in a statement or report annexed thereto the aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the Stock Exchange value of any investments of which the market value is shown and is taken

as being higher than their Stock Exchange value. The auditor must see that these requirements of the Companies Act, 1948, have been complied with.

§ 4.—Stock-in-Trade.

As the correctness of the profits of a trading concern depends, to a large extent, on the accuracy of the valuation of the stock-in-trade at the date of the Balance Sheet, the verification of this asset forms an important part of the auditor's duties. At the same time such verification is attended by many more difficulties than in the case of other assets, inasmuch as no entries will usually appear in the financial books, showing what stock-in-trade should be in hand. Where accurate stock records are kept, evidence is available which will materially assist the auditor to satisfy himself as to the correctness of the stock, but in the great majority of businesses the maintenance of such detailed accounts is not practicable. The auditor cannot be expected to verify the existence of each item of stock by actual inspection. He is not a valuer, and the technical knowledge of the trade concerned, which he may or may not possess, will not as a rule be sufficient to enable him to form an opinion as to the correct valuation of the stock. He is usually unable, therefore, to verify the existence of this asset, either by reference to the financial books or by actual inspection, and he cannot assure himself of the accuracy of its value by the methods which are available in the case of other assets, such as investments. Accordingly, the verification of this asset is usually performed by testing the accuracy of the stock sheets.

Although the above represents the view generally held in this country as to the duty and responsibility of

the auditor with regard to stock, it is prudent to point out that the accountancy profession in the United States of America has, as a result of the disclosures in the notorious *McKesson & Robins* case, formally acknowledged the physical verification of inventories to be part of normal auditing practice, and some controversy has arisen as to whether a similar procedure should not be adopted in this country. The facts of that case were that the president of McKesson & Robins, Incorporated (Maryland), in collusion with certain other of the company's high officials, fabricated and presented to the auditors a completely fictitious set of records of purchases, sales and stock inventories, which resulted in the assets being overstated in the Balance Sheet by approximately 21,000,000 dollars.

In a summary of their findings and conclusions on the case, published in 1941, the Securities and Exchange Commission stated that they found that a difference of opinion existed among accountants as to the auditor's duties and responsibilities in connection with the physical verification of quantities, quality and condition of stocks. The auditors of the company, in common with a substantial section of the profession, took the position that the verification of inventories should be confined to the records. On the other hand, a body of equally authoritative opinion supported the view, which the Commission endorsed, that auditors should gain physical contact with the inventory, either by test counts, or by observation of the taking of the inventory, or by a combination of these methods.

This view has attracted a certain amount of support in this country, and many auditors do, in fact, carry out some sort of a test check of the physical

existence of the stock. It is, however, pertinent to question the practical value of such a procedure, having regard to the auditor's unfamiliarity with the diverse types and qualities of the articles included in the inventories. The auditor should not be expected to accept responsibility for work which his professional training does not qualify him to perform efficiently, and the only physical examination of the stock that could possibly be relied upon would be one carried out by professional valuers with an expert knowledge of the particular trade.

(a) Method of Stock-taking.

Stock should be taken immediately after the close of business on the last day of the period, one person calling out the quantities and description of the goods, and another entering them on the stock sheets. The particulars so ascertained having been checked by two other clerks, a responsible official should enter the price at which each item of stock is to be taken. These will be extended by one clerk, and the calculations and casts checked by another. Each person should initial for the work he has performed, and the whole should be certified by a manager, partner, or director.

Care should be taken to see that all goods not on the premises, but which form part of the stock of the business, and in respect of which invoices have been passed through, are included. Instances of this class are stock in transit, by land or water; at the docks; in the hands of agents or customers; or at branches.

On the other hand, no item should be taken into stock in respect of which invoices have not yet been passed through the books, unless the property therein resides in the purchaser at the date of the Balance

Sheet, when it should be seen that the corresponding liability is also included. It should be ascertained that no goods are taken into stock which have been sold and already treated as sales, although not yet delivered to the customers, and in the same way no goods held on behalf of third parties, by way of consignment or agency, should be included.

Unless great care is exercised, errors are certain to arise in connection with stock-taking. In many cases the people employed to take stock are not competent to distinguish between one class of stock and another, or to realise how seriously errors of this nature may affect the accounts. Consequently, active and efficient supervision on the part of some responsible official is essential.

(b) Basis of Valuation.

Stock should be valued at cost or market price, whichever is lower at the date of the Balance Sheet.

In no case should the value be higher than cost, even though the market value has risen, as this would result in taking profit before the sale is effected and the profit earned. On the other hand, a fall in the market value, due to a fluctuation in the price, need not be considered if the value has since risen. A permanent fall in value, however, must be taken into account.

The recommendations of the Council of the Institute of Chartered Accountants on the valuation of stock-in-trade are given hereunder.

No particular basis of valuation is suitable for all types of business but whatever the basis adopted, it should be applied consistently, and the following considerations should be borne in mind:

(*a*) Stock-in-Trade is a current asset held for realisation. In the balance sheet it is, therefore, usually shown at the lower of cost or market value.

(*b*) Profit or loss on trading is the difference between the amount for which goods are sold and their cost, including the cost of selling and

delivery. The ultimate profit or loss on unsold goods is dependent upon prices ruling at the date of their disposal, but it is essential that provision should be made to cover anticipated losses.

(c) Inconsistency in method may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

The following interpretations are placed on the terms "cost" and "market value":

(a) COST.

The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

Whereas the cost of (i) and (ii) can be ascertained with substantial accuracy, (iii)—indirect or overhead expenditure—can only be a matter of calculation. If (iii) is expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade or, alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned.

The following are bases usually adopted in practice for calculating cost:—

(1) *Unit Cost.*

Upon this basis, each article, batch or parcel is valued at its individual cost.

In certain cases, such as bulk stocks, this method is not always capable of application and records, including the allocation of expenses, may become unduly complicated.

Further, it may not be practicable to apply the method to partly processed stocks or finished products where the individual units lose their identity.

(2) *First in, first out.*

This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchase.

It has the effect of valuing unsold stock in a reasonably close relation to replacement price. In certain manufacturing or producing businesses, however, it is difficult to apply accurately through the various stages of manufacture or production.

(3) *Average Cost.*

This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period after deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business.

It has the effect of smoothing out distortion of results arising from excessive, and often fortuitous, fluctuations in purchase price and production costs and is particularly suitable to manufacturing businesses where several processes are involved.

The bases referred to above are founded on the principle that "cost" is an historical fact. In some cases, however, their application is unsuitable or impracticable owing to the nature of the business and stock-in-trade is taken at a cost estimated by one of the following methods:—

(4) *Standard Cost.*

This basis entails valuing stock at a pre-determined or budgeted cost per unit. It is coming more into use, particularly in manufacturing or processing industries where several operations are involved or where goods are produced on mass production lines.

(5) *Adjusted Selling Price.*

On this basis, an estimated cost is obtained by pricing stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal.

Other methods of stock valuation are the " base stock " method, which retains permanently certain basic stock at a fixed price not exceeding its original cost, and that known as " last in, first out " which is based on the principle that profit or loss on trading is the difference between the price at which goods are sold and their replacement cost. There is, however, only limited application of either of these methods in this country.

(*b*) MARKET VALUE.

The expression " market value " is commonly interpreted as either—

(i) the price at which it is estimated that the stock can be realised either in its existing condiiton or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal; or

(ii) the cost of replacing the stock at the accounting date.

In considering the merits of these alternative methods, regard must be had to the purpose for which stock-in-trade is held, namely, to sell either in its existing condition or as incorporated in a manufactured product. The fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit is less than it might have been had it been possible to acquire them at the accounting date—a possibility which often does not exist in view of the quantity held and of the fact that in many cases purchases have to be made for later delivery; the circumstance has not caused a trading loss but only indicates that the ultimate results under other conditions might have been better.

On the other hand, if at the time of the valuation it is clear that selling prices will not cover cost and expenses yet to be incurred before the goods are disposed of, provision is necessary to meet the anticipated loss.

When estimating the amount of the provision required to cover excess of cost over market value, the method employed may be either (i) to consider each article in stock separately, (ii) to group articles in categories having regard to their similarity or interchangeability or, (iii) to consider the aggregate cost of the total stock-in-trade in relation to its aggregate market value.

RECOMMENDATION.

It is therefore recommended that—

(1) The basis of valuation for stock-in-trade should normally be the lower of cost or market value, calculated as in (2) and (3) below.

In certain businesses, such as tea or rubber producing companies and some mining companies, there is a general custom to value stocks of products at the price subsequently realised less only selling costs; if this basis is adopted, the fact should be clearly indicated in the accounts.

In the case of long-term contracts, the value placed on work-in-progress should have regard to the terms and duration of the contracts. If, after providing for all known contingencies, credit is taken for part of the ultimate profit, this fact should be indicated.

(2) Cost should be calculated on such a basis as will show a fair view of the trend of results of the particular type of business concerned. Indirect or overhead expenditure, if included as part of the cost of partly

processed or finished products, should be restricted to such expenditure as has been incurred in bringing the stock-in-trade to its existing condition and location.

Stocks of by-products, the cost of which is unascertainable, should be valued at current selling price (or contracted sale price where applicable) after deducting expenses to be incurred before disposal. The cost of the main product should be reduced accordingly.

(3) Market value should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realised, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal. In estimating this price, regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal.

If the value of stock-in-trade is calculated by reference to replacement cost, it should be described in the balance sheet as being "at the lower of cost or replacement value," but in no case should it exceed market value as described above.

(4) For the purpose of estimating the amount of the provision required to reduce stock-in-trade below cost, it may properly be valued on the basis of the lower of its aggregate cost or of its aggregate market value. On the other hand, a more prudent and equally proper course is to take each item of stock (or each category group) and value it on the basis of the lower of its own cost or market value.

(5) Where goods have been purchased forward and are not covered by forward sales, provision should be made for the excess, if any, of the purchase price over the market value and should be shown as such in the accounts.

Note.—Where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made for the excess, if any, of the anticipated cost over sales value.

(6) Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and should be applied consistently regardless of the amount of profits available or losses sustained. Any reduction in stock values which exceeds the provisions embodied in the above recommendations is a reserve and should be shown as such in the accounts.

It has been suggested that cost should be ascertained on the assumption that the last goods received were the first to be sold (this system is known as *Lifo*, the first in first out method being described as *Fifo*). The theory underlying the *Lifo* basis is that in times of rising prices the latest purchases of goods were made at prices approximating more closely to current replacement prices than were earlier purchases and that by regarding the earlier purchases as being those still in stock, regard is had for the cost of replacing the goods sold, and profits are not unduly inflated as a

result of price increases. Whilst it is true that in times of rising prices recorded profits would be lower if stock were valued on this basis, it is considered that proprietors should be given information as to the real profits made and that stock should appear in the Balance Sheet at its true cost. If it is considered that profits have been abnormal in any year because old stock has been sold at enhanced prices, it is always open to the directors to transfer the excess profit to reserve, and to explain the position in their report to the members.

Other classes of stocks may be on hand at the date of the Balance Sheet in addition to stock-in-trade proper, *e.g.*, stores for the upkeep and maintenance of plant and machinery, fuel, etc. Where these are of any consequence, it is desirable that a valuation thereof should be taken, in order that the amount charged against revenue may represent the actual quantity consumed during the period under review. In order to effect this, such stock should be brought down as a debit balance on the expenditure account to which it relates, and not included in the general total of stock-in-trade taken to the credit of the Trading Account.

(c) The Auditor's Duty in Relation to Stock-in-Trade.

The extent to which the auditor is responsible for the value of the stock-in-trade appearing in the Balance Sheet was considered in the case of the *Kingston Cotton Mill Co.* (No. 2, 1896, 1 Ch. 331), which will be fully discussed in Chapter X, § 3. It may be remarked here that the Court held that an auditor is not a valuer; that it is not his business to take stock; that in the absence of suspicious circumstances he is entitled to rely upon the representation

of responsible officials; and that he is not guilty of negligence if he accepts the certificate of such persons as to the value of the stock-in-trade.

The auditor cannot, however, confine himself to seeing that the stock is duly certified; he must, in addition, impose such tests upon the stock-sheets as are possible in all the circumstances. The tests to be imposed must depend upon the nature of the business and the records which are kept. If a proper costing system is in operation, stores and stock accounts will be maintained, and if these are tested and found to be satisfactory the auditor is entitled to rely on the quantity balances shown thereby at the date of the Balance Sheet. In some businesses it is possible to ascertain the total quantities purchased and sold during the year, so that, after adjusting for the opening stock, the approximate quantity which should be in hand at the end of the period can be determined without difficulty. In other businesses it is possible to associate each item sold with its purchase, *e.g.*, a dealer in antiques, so that by elimination the unsold items representing the closing stock can be ascertained. In the majority of businesses, however, the verification of stock is not facilitated by the nature of the business or by the records maintained, and the auditor must rely on such tests as are possible in the circumstances. The work that should be performed in most cases may be summarised as follows:—

(1) Examine the stock-sheets to ascertain that they contain only goods normally dealt in by the business, and to make sure that, in particular, the following are excluded:

(*a*) Plant, loose tools, office furniture, motor cars, and other assets already recorded separately in the books.

(b) Goods held on consignment or on sale or return. Stocks of stores, fuel, etc., should be taken at cost, and brought down on the expense accounts relating thereto.

(2) Check the rough original stock-sheets with the fair copies thereof, noting and enquiring into any material alterations.

(3) If quantity columns are maintained in the Bought and Sold Day Books verify quantities, shown thereby to be held at the balancing date, with the stock-sheets.

(4) Where quantity stock accounts or costing records are maintained, examine these to verify the quantities taken into stock. Differences that are not automatically accounted for should be enquired into.

(5) Where stock is held by agents, or in bonded warehouses, certificates should be obtained, and compared with the stock-sheets.

(6) See that all goods taken into stock are included in purchases, by examining Goods Received Books at close of period, testing the invoices for the new period, and agreeing suppliers' statements with the Ledger Accounts.

(7) See that no goods which have been included in stock have been invoiced out to customers before the balancing date. Test the Goods Outwards Book, or despatch advices from the warehouse, with Sales Day Books, seeing that items despatched after stocktaking are included in the succeeding period.

(8) See that stock is valued at cost, or below, if the market value has permanently dropped, and note the following points:—

(*a*) That obsolete or defective stock is carried forward at its true value.

(*b*) That prices of finished goods are below the listed or advertised selling prices.

(*c*) That all trade discounts have been deducted.

(9) Test prices of raw materials with bought invoices or market quotations, and values of partly or wholly manufactured goods with costing records (if any).

(10) Compare the stock sheets with those of the previous year and enquire into the major differences in prices and quantities.

(11) Compare the prices placed upon finished goods with the prices obtained therefor when sold during the succeeding period.

(12) Test the extensions and check additions.

(13) The percentage of gross profit on turnover should be checked with that of previous periods, and the cause of any material increase or decrease ascertained.

(14) See that each sheet is initialled by the parties concerned in its preparation, and that the whole is properly certified by some competent official.

The tests to be made in each case must be determined by the circumstances and the records available, but such tests as the above, though not of themselves proving the correctness of the stock, will serve to protect the auditor against any charge of negligence, should errors or fraud afterwards be discovered. Where the auditor is satisfied that the stock is correct,

it is not usual for him to refer to the matter in his report; but where, owing to the nature of the business, or to the manner in which the stock has been taken, this is not the case, it is advisable for him to state in his report that he has accepted the certificate of the officials, such statement being qualified, where necessary, according to the facts of the case.

Where stocks are in bonded warehouses, the warrants should be examined by the auditor, and certificates should be obtained for all stocks in the hands of other parties. Documents of title to stock may be lodged with bankers or others as security for advances, and in that case the auditor should obtain a certificate from such parties, and verify the amount of the loan so advanced.

§ 5.—Loans on Security.

The verification of loans on security involves not only an examination of the Loan Account in the Ledger, but also of the security lodged, in order that the auditor can satisfy himself that the loan is properly secured, and that there is a reasonable margin between the amount of the loan and the value of the security.

The fact that interest is regularly charged up and paid on the due dates, is additional evidence of the existence of the loan. Interest in arrear for any length of time may indicate that the account is doubtful, and where it is added to the amount of the debt, it should be seen that, if necessary, further security is lodged.

When the auditor does not consider the debt fully secured, and particularly in cases where the interest is accumulating without further security being lodged, he should see that proper provision is made to cover any possible loss. Where interest has not

been paid, it is sometimes left out of account altogether. This prevents the possibility of such interest being credited to revenue, and distributed as profit, when it is never likely to be received. On the other hand, such treatment does not record the actual state of the Loan Account, and in the case of banks and other concerns whose business it is to advance money, it is usual to find the interest regularly charged up, the amount of such interest either being fully provided for, or taken to the credit of an Interest Suspense Account which is brought forward as a liability, and not treated as profit until the interest is actually received.

The nature of the security lodged against loans varies with each class of business transaction. A loan on the security of land, or any estate therein, is secured by way of a mortgage, which may either be *legal*, when an actual title in the land will be conveyed, or *equitable*, which may be effected either by a written instrument termed a memorandum of deposit, or by the deposit of title deeds only.

Where the loan is secured by the transfer of possession of movable assets or by the deposit of securities, the transaction is called a pledge.

The auditor's duties in connection with the verification of the more usual classes of loans on security will now be considered.

(a) Loans on Mortgage.

On the occasion of the first audit, the mortgage deed should be examined in detail, the following points being noted :—

(1) The name of the party to whom the mortgage is granted. If a company, the names of the trustees or nominees (if any) will be

inserted, and the auditor should satisfy himself that they hold on behalf of the company.

(2) The particulars of the property mortgaged, which should correspond with the title deeds of such property.

(3) The amount of the loan, and date thereof.

(4) The rate of interest payable.

The above details are usually indorsed on the back of the mortgage, and if the auditor has verified them on the first occasion, it will not be necessary for him to examine the deed in detail at subsequent audits.

The title deeds deposited with the mortgage deed should be examined, the same considerations applying as in the case of verification of freehold and leasehold properties, referred to in § 2 of this Chapter.

If the title to the property has been registered under the Land Transfer Acts, particulars of the mortgage will be entered in the charges section of the land registry certificate, which should be examined by the auditor.

The last receipt for fire insurance should be produced, in order that it may be seen that the property is protected against fire, and in the case of leaseholds the last receipt for ground rent.

In order to verify the value of the property, and to see that there is sufficient margin of security, the auditor should inspect the valuer's certificate. Where the loan has been outstanding for some time, and there is any possibility that the value of the property has diminished, a further valuation should be made.

In the case of a second mortgage, the mortgage deed should be examined, and this should recite the prior charge. The title deeds will be in the possession of

the first mortgagee, and the auditor will therefore not be able to inspect them, but an acknowledgment should be obtained from the first mortgagee or his solicitors, stating that he has received notice of the second charge.

Where, as in the case of building societies, there is a large number of mortgage deeds, special considerations apply, which are dealt with in Chapter XII, § 5.

(b) Loans on Investments.

The auditor should examine the schedule of investments deposited as security for the loan, and verify the investments in the same manner as already described in § 3.

In-so-far as the securities deposited are to bearer, no question will arise as to transfer of the title, but in the case of registered or inscribed stocks, the auditor should see that the stocks have been actually transferred into the name of the lender or his nominee.

The deposit of the certificate issued to the borrower, accompanied by a blank transfer signed by him, which is not completed and registered immediately, though it may constitute an equitable charge, will not of itself afford a complete security. This subject is fully considered in Chapter VII, § 2 (*i*).

The values of the securities deposited should be tested by the auditor in the manner previously indicated, in order that he may ascertain whether there is sufficient margin to secure the loan fully ; and he should ascertain that the usual undertakings have been lodged to repay on demand, or at a fixed date with interest, or to deposit further security in the event of that held depreciating by reason of a fall in market values during continuance of the loan.

(c) Loans on other Security.

Goods are frequently pledged for advances. Where the goods are in transit, the complete set of bills of lading, duly indorsed in favour of the lender, will be deposited, together with the insurance policy. Where the goods are at the docks, or in bonded or other warehouses, the dock warrants or warehouse certificates, indorsed in favour of the lender, will be lodged. Where warrants or certificates have not been issued, delivery orders in favour of the lender will be lodged. Delivery, however, will not be made on such orders until all the rent and other charges accrued on the goods have been paid ; and the extent of any liability outstanding in this respect should be ascertained, as it may materially affect the value of the security. The auditor should test the value of the goods by reference to market quotations, invoices, etc.

In order to verify a loan on personal guarantee, the guarantee should be seen. Under the Statute of Frauds it is necessary that this should be in writing and duly stamped. In order to ascertain whether the loan is secured, the auditor must satisfy himself that the guarantor is good.

Loans on the security of life policies, though they may be fully covered in the event of the immediate death of the assured, should only be regarded as secured to the extent of the surrender value of the policies. The auditor should require the production of a statement from the insurance company, showing the surrender value, and ascertain that due notice of assignment has been given to the company. The last receipt for premium should be inspected.

A loan on the security of a bill of sale will be verified by inspection of that document. It should

be seen that the bill has been duly registered, and that all the requirements of the Bills of Sale Act, 1882, have been complied with.

§ 6.—Bills Receivable.

The balance of the Bills Receivable Account in the Impersonal Ledger will represent bills in hand at the date of the Balance Sheet, and if the auditor attends on that date he should inspect the actual bills. In most cases, however, the verification will take place after the date in question, and consequently, the bills that have been met subsequently will be verified by vouching the cash received. In the case of bills discounted since the date of the Balance Sheet, the receipt of the proceeds will be verified.

In examining the bills the auditor should see that they are properly drawn and stamped, and that they are not overdue. Where there is any doubt as to whether the bills will be met, inquiries should be made, and it should be seen that sufficient provision has been made for any loss likely to be sustained. Where a bill has been retired since the date of the Balance Sheet, the new bill should be seen; and where part of the original bill has been paid, it should be seen that the proceeds have been received, and that a new bill has been obtained for the balance.

Where transactions in bills are numerous, it is usual to place the bills in the hands of bankers or other agents for collection, when a Bills Collection Ledger will generally be found, containing accounts with each bank or other party to whom bills are handed for collection, the Bills Receivable Account being credited and such parties being debited. The balances on such accounts will represent bills in the hands of those

parties at the date of the Balance Sheet, and certificates should be obtained from them detailing the bills held at that date. The examination of such certificates by the auditor will be sufficient verification.

The auditor should see that a note of the contingent liability in respect of bills discounted outstanding appears on the Balance Sheet, and that proper provision has been made in respect thereof if necessary.

§ 7.—**Other Assets.**

(1) *Book Debts.*

The verification of book debts has already been dealt with at length in Chapter III, § 9 (*c*).

(2) *Cash at Bank and in Hand.*

The verification of cash in hand and at bank on current or deposit account, and of the petty cash balance, has been dealt with in Chapter II, §§ 6 and 7.

(3) *Endowment Policies.*

Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures, and other policies of a similar nature, should be verified by inspection of the policies, and the auditor should ascertain that the last premium has been duly paid.

(4) *Assets abroad.*

Where the documents of title relating to assets abroad are not in this country, a certificate should be obtained from the agent, or other party holding the documents or, in the case of land, a certified extract from the Local Land Registry should be submitted, and the auditor should state in his report what evidence has been produced.

(5) *Machinery and Plant.*

Although machinery and plant may form a considerable item in the assets of a business, it is normally impracticable for the auditor to verify its existence in the same manner as other assets dealt with in this Chapter, and somewhat similar considerations apply as in the case of stock. The evidence obtained by him in the course of vouching the expenditure incurred on this asset will serve to verify its existence, subject to due consideration of the questions of depreciation and repairs.

Where plant is revalued, either for fire insurance purposes or otherwise, the valuation should be examined by the auditor, and if it is below the book value he should ascertain the cause of the difference.

In the case of loose tools and plant, it is usual for a valuation to be taken each year, and the item treated in the same manner as stock. Where this is done, the auditor will examine the valuation sheets, and ascertain that they are properly certified.

(6) *Patents.*

In order to verify the existence of a patent, the actual patent should be examined: and where the patent has been purchased from another party, the assignment as well as the patent should be inspected, and it should be seen that it has been duly registered. Patents taken out by companies are, in the first instance, registered in the name of the company and of an individual, who is technically the inventor, since patent law requires that an invention can be protected only upon the application of an *individual.* In most cases the individual is only an employee of the company, who has no interest in the patent, and in such

circumstances the auditor should inspect a registered assignment by the individual. Where a considerable number of patents is held, a schedule should be presented to the auditor, containing their registered number, date, description, and number of years unexpired. The last renewal certificate should also be examined, as unless this is taken out at the prescribed time, the patent will lapse. Where patents are held by a company, a resolution should be passed in respect of all patents allowed to lapse.

The question of the valuation of patents for Balance Sheet purposes has been considered in Chapter IV, § 6 (*b*).

(7) *Copyrights.*

Copyright was created by the Copyright Act, 1911, and means the sole right to produce or reproduce the work or any substantial part thereof in any material form whatsoever, to perform, or in the case of a lecture to deliver, the work or any substantial part thereof in public ; if the work is unpublished, to publish the work or any substantial part thereof ; and shall include the sole right—

(*a*) to produce, reproduce, perform, or publish any translation of the work ;

(*b*) in the case of a dramatic work, to convert it into a novel or other non-dramatic work ;

(*c*) in the case of a novel or other non-dramatic work, or of an artistic work, to convert it into a dramatic work, by way of performance in public or otherwise ;

(*d*) in the case of a literary, dramatic, or musical work, to make any record, perforated roll,

cinematograph film, or other contrivance by means of which the work may be mechanically performed or delivered,

and to authorise any such acts as aforesaid.

Subject to the provisions of the Act, the author of the work is the first owner of the copyright therein, and the term for which copyright subsists is, with certain exceptions, the life of the author and a period of 50 years after his death.

If the copyright is assigned, the assignment must be in writing and should be examined by the auditor. The question of the valuation of copyrights has been treated in Chapter IV, § 6 (*b*).

CHAPTER VI

THE AUDITOR OF A LIMITED COMPANY

§ 1.—The Appointment and Remuneration of Auditors.

Many changes in the duties imposed upon auditors and in their appointment were introduced by the Companies Act, 1947. This Act was consolidated with the Companies Act, 1929, to form the Companies Act, 1948, and all references to "the Act" are to the latter enactment.

(a) Auditors appointed on behalf of the Company.

The appointment of auditors is dealt with in Section 159, Companies Act, 1948, the provisions of which are as under:—

(1) Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.

(2) At any annual general meeting a retiring auditor, however appointed, shall be reappointed without any resolution being passed unless—

- (*a*) he is not qualified for reappointment; or
- (*b*) a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed; or
- (*c*) he has given the company notice in writing of his unwillingness to be reappointed:

Provided that where notice is given of an intended resolution to appoint some person or persons in place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with, the retiring auditor shall not be automatically reappointed by virtue of this subsection.

(3) Where at an annual general meeting no auditors are appointed or reappointed, the Board of Trade may appoint a person to fill the vacancy.

(4) The company shall, within one week of the Board's power under the last foregoing subsection becoming exercisable, give them notice of that fact, and, if a company fails to give notice as required by this subsection, the company and every officer of the company who is in default shall be liable to a default fine.

(5) Subject as hereinafter provided, the first auditors of a company may be appointed by the directors at any time before the first annual general meeting, and auditors so appointed shall hold office until the conclusion of that meeting:

Provided that—

(*a*) the company may at a general meeting remove any such auditors and appoint in their place any other persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting; and

(*b*) if the directors fail to exercise their powers under this subsection, the company in general meeting may appoint the first auditors, and thereupon the said powers of the directors shall cease.

(6) The directors may fill any casual vacancy in the office of auditor, but while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

(b) The qualification required for appointment as auditor of a Company.

Except in the case of an auditor of an exempt private company, the auditor of a company must possess the qualification required by Section 161 (1) Companies Act, 1948, which is given hereunder:—

(1) A person shall not be qualified for appointment as auditor of a company unless either—

(*a*) he is a member of a body of accountants established in the United Kingdom and for the time being recognised for the purposes of this provision by the Board of Trade; or

(*b*) he is for the time being authorised by the Board of Trade to be so appointed either as having similar qualifications obtained outside the United Kingdom or as having obtained adequate knowledge and experience in the course of his employment by a member of a body of accountants recognised for the purposes of the foregoing paragraph or as having before the sixth day of August, nineteen hundred and forty-seven, practised in Great Britain as an accountant.

The bodies of accountants recognised by the Board of Trade under Subsection 1 (*a*) are given in the Appendix hereto.

As indicated, the professional qualification required of an auditor does not apply to the auditor of an *exempt private company* and, therefore, it is possible for persons with no accountancy qualifications to act as auditor of such companies. In view of the fact that the majority of small private companies, whose accounting records are usually far from satisfactory, are exempt private companies, it is unfortunate that where professional auditors are most necessary they are not legally essential.

An exempt private company is a private company which satisfies the following conditions :—

(*a*) That no body corporate is the holder of any of its shares or debentures.

(*b*) That no person other than the holder has any interest in any of the shares or debentures.

(*c*) That the number of persons holding debentures of the company is not more than fifty (joint holders being treated as a single person).

(*d*) That no body corporate is a director of the company, and neither the company nor any of the directors is party or privy to any arrangement whereby the policy of the company is capable of being determined by persons other than the directors, members and debenture holders, or trustees for debenture holders.

Exceptions to condition (*b*) are provided by the Seventh Schedule to the Companies Act, 1948, and in the following circumstances, the fact that a person

other than the holder has an interest in the shares or debentures will not affect the exemption of the company:

(*a*) if any share or debenture is subject to a charge in favour of a banking or finance company by way of security for the purposes of a transaction entered into in the ordinary course of business, then the interest of that banking or finance company is disregarded;

(*b*) if any banking or finance company or its nominee is the holder of any share or debenture as security, then the person entitled to the equity of redemption in that share or debenture shall be treated as the holder;

(*c*) any interest under a contract for the transfer of a share or debenture shall be disregarded until execution of an instrument of transfer unless the execution thereof is unreasonably delayed. On execution of the transfer, the transferee will be the holder of the shares unless the company refuses to register the transfer;

(*d*) any interest of the company itself in any of its shares or debentures and any lien or charge thereon arising by operation of law shall be disregarded;

(*e*) shares or debentures forming part of the estate of a deceased person so long as the administration of his estate is not completed;

(*f*) shares or debentures held by a trustee on the trusts of a will or family settlement disposing of those shares or debentures so long as no body corporate has any immediate interest therein under the trust;

(*g*) shares or debentures vested in a trustee or administrator or other person acting for a person of unsound mind;

(*h*) shares or debentures held by a trustee for the purpose of a scheme maintained for the benefit of employees of the company, including any director holding a salaried employment or office in the company;

(*i*) shares or debentures held by a banking or finance company or its nominee acquired in the ordinary course of business, but this exception will not apply if one-fifth or more of the shares carrying voting power are held in this way;

(*j*) any shares or debentures forming part of the assets in a bankruptcy or liquidation of a holder thereof or held on trusts created for his creditors or held for the purpose of a composition or scheme made or approved by the Court.

A company is still an exempt private company even though some of its shares are held by a body

corporate, provided that such body corporate is itself an exempt private company. This exemption only applies, however, if, taking all the companies concerned, *i.e.*, the company, the company holding the shares and any other company concerned, the combined membership is not more than fifty, excluding the companies themselves and their past and present employees.

Apart from the disqualifications from appointment as auditor on the grounds of competence as explained above, the following persons are not qualified to act as auditors of a company :—

(*a*) An officer or servant of the company ;

(*b*) A person who is a partner of or in the employment of an officer or servant of the company ;

(*c*) a body corporate ;

(*d*) A person who, for one of the reasons given above, is disqualified from acting as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company or would be so disqualified if the body corporate was a company.

The disqualification provided by (*b*) above does not apply to the auditor of an exempt private company.

Any body corporate which acts as auditor of a company is liable to a fine not exceeding £100.

In view of the uncertainty as to whether some of the duties often undertaken by accountants on behalf of a company might disqualify them or their partners from acting as the company's auditors, the Institute of Chartered Accountants obtained counsel's opinion as to the position where an accountant acts in any of

the following capacities. The opinion is summarised hereunder :—

(i) *Registrar.* A registrar is not an officer of the company provided that his contract with the company is "for services" and not "of service."

(ii) *Financial Adviser.* A financial adviser or consultant is not a servant of the company unless the company has the right to control his services.

(iii) *Employee of Auditor.* An accountant is not disqualified from appointment as auditor of a company by reason of the fact that his employee acts as a director, secretary or otherwise as an officer of the company.

(iv) *Liquidator or Receiver.* The appointment of an accountant as liquidator or receiver of a company does not disqualify him or his partner from appointment as auditor of a subsidiary, holding company or fellow subsidiary of that company or, in the case of a receiver, as auditor of the company itself. If, however, an accountant is appointed *receiver and manager* of a company, he will be an officer of the company and the disqualification will, therefore, apply.

(c) The Auditor's Remuneration.

By Section 159 (7) Companies Act, 1948, the remuneration of the auditors of a company—

(*a*) in the case of an auditor appointed by the directors or by the Board of Trade, may be fixed by the directors or by the Board, as the case may be;

(*b*) subject to the foregoing paragraph, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

For this purpose the expression "remuneration" includes sums paid by the company in respect of the auditor's expenses. If the auditor's remuneration is not fixed by the members in general meeting, the amount thereof must be shown separately in the company's Profit and Loss Account (8th Schedule, Part 1). In those cases where the exact remuneration and expenses cannot be determined at the date when the accounts are completed, the Council of the Institute of Chartered Accountants recommend that "an estimated amount should be included in the accounts, and any subsequent adjustment, if material in relation to the estimated amount previously disclosed, should be shown in the accounts of the following period."

In many cases in practice, auditors charge an inclusive fee for auditing the company's books and other work, *e.g.*, secretarial, taxation and accountancy matters. In these circumstances it is recommended by the Council of the Institute that the remuneration, shown separately in the company's Profit and Loss Account, "should be limited to or specified separately as the remuneration for the auditors duties under the Act. The fees for other professional services should be treated as a general expense of the business."

(d) The Removal of Auditors.

As explained above, when the first auditors of a company are appointed by the directors prior to the first annual general meeting, such auditors may be removed by the members in general meeting. When it is desired to appoint a person other than the retiring auditor as auditor of the company at the annual general meeting, notice of the intention to move such a resolution must be given to the company by a share-

holder not less than twenty-eight days before the annual general meeting. If, after such special notice has been given, the annual general meeting is called for a date twenty-eight days or less after the notice has been given, the notice, although not within the time prescribed, will be deemed to have been properly given. On receipt of such a notice the company must forthwith send a copy to the retiring auditor.

If he wishes to do so, the retiring auditor, after receipt of the notice intimating that a resolution is to be moved appointing another person in his place or that he shall not be reappointed auditor of the company, may make representations to the company in writing (not exceeding a reasonable length) and ask for such representations to be sent to the members of the company (Section 160 (3) Companies Act, 1948). On receipt of such representations the company must, unless it is too late to do so—

(*a*) State the fact that such representations have been made in any notice of the resolution sent to members; and

(*b*) Send a copy of the representations to every member of the company to whom notice of the meeting is sent (whether before or after receipt of the representations by the company).

If a copy of the representations is not sent to the members either because it was received too late to do so, or because of default by the company, the auditor may insist that the representations shall be read out at the meeting. The Act provides, however, that copies of the representations need not be sent out, and the representations need not be read out at the meeting if, on the application either of the company or of any

other person who claims to be aggrieved, the Court is satisfied that the rights conferred upon the auditor by Section 160 are being abused to secure needless publicity for defamatory matter. In these circumstances the Court may order the company's costs on an application to be paid in whole or in part by the auditor, notwithstanding that he was not a party to the application. The first auditor of a company has a similar right to make representations when notice is given of an intention to remove him at a general meeting.

It must, of course, be remembered that in addition to his right to make written representations, the retiring auditor has the power to attend the annual general meeting at which his removal is to be proposed and to address the members.

It will be observed, that although the directors have power to appoint the first auditors before the first annual general meeting, such auditors can be removed by resolution of the company in general meeting, and in this way the ultimate right of appointment rests with the members in every instance, with the exception of a casual vacancy. This emphasises the fact that the auditor is responsible to the members, and acts on their behalf, and not on behalf of the directors. In actual practice, as the directors are agents for the members in conducting the affairs of the company, the auditor will naturally come into personal contact with them in the course of his duties, and he will sometimes meet directors who seem to consider that the auditor exists merely to seal with his official approval the accounts presented by the Board; but it must be remembered that the auditor is the representative of the members, and his statutory duties are owed to them.

The clause relating to the appointment of an auditor, other than a retiring auditor, was first introduced in the Companies Act, 1907, owing to the method, sometimes adopted by directors, where there was a difference of opinion between the retiring auditor and themselves, of nominating another auditor without notifying the retiring auditor of their intention so to do, and carrying the appointment of the new auditor by means of the proxies at their disposal. Such procedure was in many cases detrimental to the general interests of the members, and was certainly a very poor reward for the auditor who had too faithfully discharged his duties to them. The fact that notice must be sent to the retiring auditor, and to all members prior to the general meeting, in the event of any auditor other than the retiring auditor being nominated, prevents any alteration in the appointment without the knowledge of all the members.

The right to make written representations was conferred upon the retiring auditor for the first time by the Companies Act, 1948.

Before allowing himself to be nominated as auditor in place of a retiring auditor, a person must communicate with the retiring auditor to ascertain whether he knows of any reason why the nomination should not be accepted. Failure to do this is regarded as a breach of professional etiquette, and is liable to evoke disciplinary action by the governing bodies of the accountancy profession.

(e) Joint Auditors.

Two or more auditors are sometimes appointed, particularly in the case of large concerns, such as banking or insurance companies, or where the regulations of the company so require. In such cases each

auditor is jointly responsible; but where the work performed by the auditors is divided by mutual agreement, it may be desirable for each auditor to avoid responsibility for work he has not performed, by a specific statement in the report as to the extent of the audit carried out by each.

(f) Local Auditors.

Companies carrying on business abroad, such as those possessing foreign branches or mines, frequently employ a local auditor or auditors, who audit the accounts locally and report upon them before their transmission to the head office. Such auditors may be appointed by the London board of directors or by the local board, or their appointment may be made by the members in general meeting. The latter course is preferable, as it renders the local auditors more independent, and they become directly responsible to the members.

Where a local audit of this nature is performed, the company's auditor will not examine the returns rendered in detail, but will confine himself to questions of principle, and to ascertaining that the accounts are properly incorporated in the head office books. In his report he should state that he has accepted the foreign returns as certified by the local auditor.

§ 2.—The Status of the Auditor.

(a) As Agent of the Members.

The question as to how far the auditor is the agent of the members was discussed in *Spackman* v. *Evans* (3 H.L. 236), when Lord Chelmsford dissented from the view expressed in a previous case, that the auditors were, within the scope of their duty, at least as much the agents of the members as the directors.

He added, "It seems to me that it would be an unreasonable conclusion from this mode of appointment of these officers, that they were thereby constituted agents so as to conclude the shareholders by their knowledge of any unauthorised acts of the directors."

Lord Cranworth stated in the course of the same case: "The auditors may be agents of the shareholders, so far as relates to the audit of the accounts. For the purposes of the audit, the auditors will bind the shareholders."

(b) As an Officer of the Company.

The question as to whether an auditor is an officer of the company is of particular importance, as it is only in his capacity as officer that he can be held liable under Section 333 of the Companies Act, 1948, to contribute to the company, in the event of winding-up, any loss occasioned by misfeasance or breach of trust on his part. In the case of the *London & General Bank* (No. 1, 1895, 2 Ch. 166) it was held that the auditor of a banking company, registered under the Companies Act, 1879, is an officer of the company. Lindley, L. J., read the section of that Act relating to auditors, and said: "It seems impossible to deny that for some purposes, and to some extent, an auditor is an officer of the company. He is appointed by the company, he is paid by the company, and his position is described in the section as that of an officer of the company. He is not a servant of the directors. On the contrary, he is appointed by the company to check the directors, and for some purposes, and to some extent, it seems to me quite impossible to say that he is not an officer of the company." The Articles of this particular company frequently referred

to the auditor as an officer of the company, and thus further influenced the decision.

In the case of the *Kingston Cotton Mill Co., Ltd.* (1896, 1 Ch. 6), the Articles of the company relating to the audit of the accounts were, in substance, the same as the audit clauses of Table "A" to the Companies Act, 1862 ; but the Articles did not specifically refer to the auditors as officers of the company. Notwithstanding this, it was held that there was no specific distinction between this case and that of the *London & General Bank,* and that the auditor was an officer.

An auditor who has never been properly appointed is not an officer of the company (*Western Counties Steam Bakeries & Milling Co., Ltd.*, 1897, 1 Ch. 617).

There has been no further decision on the subject, but it would seem that since Section 159 of the Companies Act, 1948, quoted above, refers to the " office of auditor " in terms similar to the Act of 1879, an auditor would be held to be an officer of the company, in-so-far as his duties as auditor are concerned.

There are numerous sections of the Companies Act, 1948, under which, if default is made in complying with the requirements thereof, the company, and every director, manager, secretary, or other officer of the company, who is knowingly a party to the default, are liable to fines varying in amount according to the offence ; and it is interesting to consider whether an auditor who, in the course of his duties, becomes aware of a default of this nature, might be held liable as being an officer of the company. The point has not yet come before the Courts, but it is one of some practical importance, as from time to time the auditor does become aware of such defaults. The question then arises as to his duty in these

circumstances, particularly where the default is persisted in. Probably it would be sufficient for him to give the company notice in writing of his knowledge of the default, pointing out the consequences thereof, and dissociating himself from any responsibility in connection with it. If he has done this, it cannot well be said that he continues to be knowingly a party to the default. In any event, it could hardly be maintained that an auditor is an officer of the company for the purpose of making returns to the Registrar of Companies.

§ 3.—The Powers of the Auditor.

Section 162 (3) Companies Act, 1948, provides that every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

It will be observed that the auditor has a right of access at all times to the books, accounts, and vouchers of the company. He can therefore inspect these at any time he chooses. In practice, it is usual for the auditor to arrange a date with the directors, and it is not customary for him to attend without giving due notice. It is important, however, for the auditor to remember that he has a statutory power to attend without notice, and it may be necessary for him to exercise this power in cases where he suspects fraud or irregularity.

The phrase " books, accounts and vouchers " will include, not only the financial books of the company, but all the books, whether statutory, statistical, or

memoranda. In a similar manner the term "vouchers" will include all or any of the correspondence of the company which may in any way serve to vouch for the accuracy of the accounts.

In a case where negligence was alleged against the auditors by the directors of a company who refused them access to the books for the purposes of the audit, the Court refused to make an order on the application of the auditors for access to the books, it being the practice of the Court, in cases affecting internal management, to direct that a meeting of members be summoned to determine their wishes in the matter (*Cuff* v. *London and County Land and Building Co.*, 1912, L.J. C.A. 426). The auditors are the servants of the company, appointed by the company, and if the company does not desire them to act, no Court will, by mandatory injunction, force them upon it.

The power entitling the auditor to require from the directors and officers of the company such information and explanations as he thinks necessary for the performance of his duties as auditor, is a most important one. The power is very wide, and the decision as to what information and explanation is necessary is left entirely to the discretion of the auditor. If information or explanation is refused, on the ground that the directors consider it is not necessary for the performance of the duties of the auditor, the auditor can report to the members that he has not obtained all the information and explanations he has required.

The auditor is required to report to the members on the accounts examined by them. It is the duty of the directors to prepare the accounts for presentation to the auditor, and consequently the books ought to be presented to the auditor balanced. It cannot be said

to be the duty of the auditor to balance the books, neither should he undertake to do so, unless specially requested by the directors, when he will be acting in the capacity of accountant, and not as auditor. Any additional work of this nature should be specially remunerated.

Where the company's accounts are kept on a system of which the auditor does not approve, he cannot *require* the directors to amend their system, but he can *request* them to do so, and in the majority of cases the auditor's advice will be followed. Where, however, the suggestions are not carried out, he should refer the matter to the members, if in his opinion the system employed is detrimental to their interests. Should the method of recording the accounts be so inadequate as to result in insufficient evidence being available, the auditor must state in his report to the members that, in his opinion, proper books of account have not been kept by the company.

Under Section 162 (4) the auditor has power to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive. The auditor may make any statement or explanation with regard to such accounts as he may desire. This power to make explanations at the meeting does not absolve the auditor from making a clear and unambiguous report in the usual manner under Section 162 (1), *see infra*. Thus, the auditor cannot avoid liability for omissions or inaccuracies in the accounts merely by making a verbal explanation to such members of the company as are present at the annual general meeting.

§ 4.—The Duties of the Auditor.

Section 162 (1) Companies Act, 1948, provides that the auditors shall make a report to the members on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the Ninth Schedule to the Act.

The following are the matters to be expressly stated in the auditor's report to the members in accordance with the requirements of the Ninth Schedule :—

1. Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

2. Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

3.—(1) Whether the company's Balance Sheet and (unless it is framed as a consolidated Profit and Loss Account) Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

(2) Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by this Act in the manner so required and give a true and fair view—

(*a*) in the case of the Balance Sheet, of the state of the company's affairs as at the end of its financial year ; and

(*b*) in the case of the Profit and Loss Account, of the profit or loss for its financial year ;

or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the **Eighth Schedule** to this Act are not required to be disclosed.

4. In the case of a holding company submitting group accounts whether, in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the

company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the **Eighth Schedule** to this Act are not required to be disclosed.

Under Section 134 (1) Companies Act, 1929, the auditor was required to report to the members on the company's Balance Sheet, no mention being made of the Profit and Loss Account. Some doubt was frequently expressed as to whether the auditor had any responsibility for the accuracy of the Profit and Loss Account, but whatever doubt may previously have existed has been cleared up by the Companies Act, 1948, which clearly imposes upon the auditor the duty of reporting upon the Profit and Loss Account. It will also be observed that the auditor must report whether the Profit and Loss Account gives a true and fair view of the profit or loss *for the financial year*. Clause 14 (6) of the Eighth Schedule to the Act provides that if not otherwise shown in the accounts the following matters shall be stated by way of a note :—

Any material respects in which any items shown in the Profit and Loss Account are affected—

(*a*) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature ; or

(*b*) by any change in the basis of accounting.

In some businesses, *e.g.*, builders, contractors and civil engineers, owing to the time which usually must elapse before final accounts, claims for increased costs, etc., can be agreed with surveyors and government departments, the profit of an accounting period may often be augmented by additional claims settled in respect of contracts completed in earlier years for which provision was not made at the time. If such amounts are material, they must be shown separately

in the Profit and Loss Account, otherwise the auditor must qualify his report on the grounds that the profit disclosed does not represent *the profit for the financial year*. If in such cases the auditor is of the opinion that further material sums will be received in respect of completed contracts for which no provision has been made in the accounts, he must mention this matter in his report unless an adequate note covering the position has been made by the directors on the accounts.

No limitation can be placed upon the duties of the auditor under Section 162, either by the Articles of the company or by any resolution of the members.

In the case of *Newton* v. *Birmingham Small Arms Co.* (1906, 2 Ch. 378), the Articles of the company provided :—

(*a*) That the directors should have power to form an *internal* reserve fund which was not to be disclosed in the Balance Sheet, and which should be utilised in whatever way the directors thought fit.

(*b*) That the auditors should have access to the accounts relating to such reserve fund, and that it was their duty to see that the reserve fund was applied to the purposes of the company as specified in the special Articles, but that they should not disclose any information with regard thereto to the shareholders or otherwise.

These provisions were held to be *ultra vires* as being a limitation of the statutory duties of the auditors.

Buckley, J., said : " Any regulations which precluded the auditors from availing themselves of all the information to which under the Act they are

entitled, as material for the report which under the Act they are to make as to the true and correct state of the company's affairs, are, I think, inconsistent with the Act."

The auditor is not required to *certify* the correctness of the Balance Sheet; all he is required to do is to *report* to the members whether in his opinion it is correct. The phrase, "according to the best of their information and the explanations given to them," was first inserted in the Companies Act, 1907; and although it limits the liability of the auditor in one sense, it extends it in another. The auditor will not be held responsible if he has acted on information and explanations which he believes to be *bonâ fide*, but which are as a matter of fact untrue or incorrect, provided he has exercised reasonable skill and diligence in testing the information supplied to him. On the other hand, the Balance Sheet may be correct as shown by the books of the company, but there may be information at the disposal of the auditor which would indicate that the books themselves were incorrect, and he cannot report to the members in the terms of the Act, unless he takes account of such knowledge.

In the same manner the phrase, "are in agreement with the books of account and returns," limits the liability of the auditor to some extent. He cannot be held responsible for transactions which are omitted from the books, unless by the exercise of reasonable skill and diligence he *could* have discovered them. At the same time the duty of the auditor is not confined to comparing the Balance Sheet with the books to see that it agrees therewith. On this point the remarks of Lindley, L. J., *In re London & General Bank* (No. 2, 1895, 2 Ch. 682), are pertinent:—

"....The auditor's business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry, and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce..... The auditor, however, is not bound to do more than exercise reasonable care and skill in making the inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs.... .His obligation is not so onerous as this..... He must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

Further duties falling upon the auditor under the Companies Act, 1948, are referred to in Section 130, under which the auditor, if appointed before the statutory meeting of a *public* company, must certify the statutory report issued to the members, so far as it relates to cash received in respect of shares allotted and to the receipts and payments by the company on capital account; in the Fourth Schedule, Part II, in connection with the report on the profits and losses, assets and liabilities of, and dividends paid by the company to be included in the Prospectus. There is also a special obligation imposed upon the auditor to ascertain that information with regard to loans to, and remuneration paid to directors is correctly exhibited in the accounts to be laid before the company, otherwise he must, as far as possible, include in his report a statement giving the required particulars. These matters will be more fully considered in Chapter VII.

Private companies are not required to hold a statutory meeting and, therefore, no statutory report has to be filed.

It is sometimes assumed that because the great bulk of the shares in a private company are held by

one or two individuals, who may be directors, such persons have the right to vary the duties of the auditor, and place restrictions upon what he shall or shall not do. It need hardly be pointed out that any such attempt to limit the rights and duties of the auditor is *ultra vires.*

In *Pendlebury's Ltd.* v. *Ellis Green & Co.*, however, it was held that where the directors of a private company are the sole shareholders, a report by the auditor made personally to the directors that he has been unable to verify to his complete satisfaction the entries in the company's Cash Book, owing to the inadequacy of the system in force, will be sufficient to relieve the auditor from liability for not including the relevant information in his report attached to the Balance Sheet. The learned judge stated that, in considering the duty which the auditor owes to the members, some distinction must be drawn between a company with a large number of shareholders who take no part in the management of the business, and one with only two or three shareholders who happen also to be the directors, and to whom the auditor has communicated the information personally.

§ 5.—The Auditor's Report.

Where the auditor is satisfied that the Balance Sheet and Profit and Loss Account are in order, the following form of report is recommended :—

Report of the Auditor to the Members of X. Ltd.

I have obtained all the information and explanations which to the best of my knowledge and belief were necessary for the purposes of my audit. In my opinion proper books of account have been kept by the company so far as appears from my examination of those books *and proper returns adequate for the purposes of my audit have been received from branches not visited by me.* I have examined the above Balance Sheet and annexed Profit and Loss Account which are in agreement with the books and accounts *and returns.*

In my opinion and to the best of my information and according to the explanations given to me the said accounts give the information required by the Companies Act, 1948, in the manner so required and the Balance Sheet gives a true and fair view of the state of the company's affairs as at ...... and the Profit and Loss Account gives a true and fair view of the profit (or loss) for the year ended on that date.

The words given in italics will only be used when appropriate. If the accounts on which the auditor is reporting are not self-contained because material information is given in the directors' report or in other documents annexed to the accounts, reference to the specific documents which must be read as part of the accounts must be made by the auditor in his report in terms which identify clearly the source to which the reference is made.

Under Part III, Eighth Schedule, Companies Act, 1948, banking, discount and assurance companies are exempted from disclosing certain information in their accounts, and other companies may obtain exemption by consent of the Board of Trade. When the auditor is reporting upon the accounts of such companies, he should state in his report that the Balance Sheet and Profit and Loss Account give a true and fair view "subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to the Act are not required to be disclosed."

The form of report recommended where the auditor reports on group accounts is given in Chapter IX.

Where the auditor is of opinion that the Balance Sheet does not give a true and fair view of the state of the company's affairs, or, that the Profit and Loss Account does not give a true and fair view of the profit for the year ended on that date, he must qualify

his report accordingly. The most common reasons for the qualification of the report are where the auditor has been unable to verify to his satisfaction the existence of certain assets; where, in his opinion, there has not been sufficient provision for depreciation, or where he is not satisfied that the assets are valued correctly.

It sometimes happens that the auditor does not agree with the treatment of certain items in the Balance Sheet presented to him for audit, and the directors do not see their way to make such alterations as the auditor may suggest. In such a case the auditor must qualify his report.

The following is an illustration of a qualification in an auditor's report:—

I have not inspected the titles to Freehold and Leasehold properties, all of which are registered or held abroad. The profit disclosed for the year includes the sum of £5000, received in settlement of claims in respect of work completed in previous years. Subject to the foregoing, in my opinion. . . .

Strong pressure is sometimes put upon the auditor to induce him to refrain from making certain comments in his report, on the ground that the fact of his doing so will be detrimental to the interests of the members, and he is sometimes asked whether he cannot indicate in more or less general terms the point at issue without specifically stating the facts. The auditor who allows himself to be persuaded to do this runs the very serious risk of being held to have failed in discharging his duty to the members.

Lindley, L. J., said, *In re London & General Bank* (No. 2, 1895, 2 Ch. 682):—

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them or some of them to ask for more. Information and means of information are by no means equivalent terms. . . . . An auditor who gives shareholders the means of information instead of information in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held judicially to have failed to discharge his duty."

§ 6.—The Publication of the Balance Sheet and Auditor's Report.

Section 155 of the Companies Act, 1948, provides that—

(1) Every Balance Sheet of a company shall be signed on behalf of the board by two of the directors of the company, or if there is only one director, by that director.

(2) In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine, the Balance Sheet must be signed by the secretary or manager, if any, and where there are more than three directors of the company by at least three of those directors, and where there are not more than three directors by all the directors.

(3) If any copy of a Balance Sheet which has not been signed as required by this section is issued, circulated or published, the company, and every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds.

Section 156 provides that—

(1) The Profit and Loss Account and so far as not incorporated in the Balance Sheet or Profit and Loss Account any group accounts laid before the company in general meeting, shall be annexed to the Balance Sheet, and the auditor's report shall be attached thereto.

(2) Any accounts so annexed shall be approved by the Board of Directors before the Balance Sheet is signed on their behalf.

(3) If any copy of a Balance Sheet is issued, circulated or published without having annexed thereto a copy of the profit and loss account or any group accounts required by this section to be so annexed, or without having attached thereto a copy of the auditor's report, the company and every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds.

It is important to observe that the auditor's report must be *attached* to the Balance Sheet, and a reference thereto inserted at the foot of the Balance Sheet is not legal. The report must be read before the members in general meeting and is open to inspection by any member.

Although it is considered that it is not the duty of the auditor to see that the Balance Sheet is signed by the required number of directors, it is customary for

the auditor to obtain the directors' signature before attaching and signing his report.

The rights of members and others to receive copies of the Balance Sheets, etc., are as follows (Section 158):

(*a*) A copy of every Balance Sheet including every document required by law to be annexed thereto, which is to be laid before the company in general meeting; and

(*b*) A copy of the auditor's report

shall be sent to—

(1) Every member of the company (whether he is or is not entitled to receive notices of general meetings); and

(2) Every debenture holder

not less than twenty-one days before the meeting.

The above provisions do not apply in the case of a company not having a share capital to members and debenture holders who are not entitled to receive notices of general meeting.

There is no longer any distinction for this purpose between public and private companies or between the holders of ordinary and preference shares.

In re Allen Craig & Co. (London) Ltd. (1934, 50 T.L.R. 301), it was held that the duty of the auditors, after having affixed their signatures to the report annexed to a Balance Sheet, is confined to forwarding that report to the secretary of the company, leaving the secretary or the directors to convene the general meeting and send the Balance Sheet and report to the members entitled to receive it. It is no part of the duty of the auditors to send a copy of their report to each member individually.

§ 7.—The Auditor's Lien.

An accountant has probably a lien on account books for charges incurred in the writing up of such books (*Burleigh* v. *Ingram Clarke, Ltd.*, 1901, 27, Acct. L.R. 65); but it is doubtful whether an auditor has such a right in respect of books which he has audited, even though he properly obtains absolute possession of such books, and improves the records therein during the course of his audit.

In *re Arthur Francis, Ltd.* (1911, 44, Acct. L.R. 61), a lien was claimed on books and documents in the possession of accountants on the ground that they had worked upon them and had not been paid either their audit fees or accountancy charges. Swinfen Eady, J., made an order that the books should be produced to the liquidators of the company without prejudice to the lien, if any, of the respondents.

CHAPTER VII

THE AUDIT OF A LIMITED COMPANY

§ 1.—Considerations on Appointment as Auditor.

The general considerations on the commencement of a new audit have been dealt with in Chapter I, § 5 (*b*), and the importance of obtaining a list of the books in use and a statement of the system of internal check (if any) in operation has been pointed out. In the case of a limited company, there are further points which the auditor should consider at this stage :—

(a) The Appointment of the Auditor.

If the company is a new one, the directors will probably have exercised this power to appoint the auditor prior to the first annual general meeting ; and if the auditor is so appointed, he should obtain from the secretary of the company a copy of the directors' minutes recording his appointment. If appointed by the company in general meeting, in succession to a previous auditor, he should obtain a copy of the resolution, and ascertain that due notice of his intended nomination was given to the company, in the first place, and subsequently to the members and the retiring auditor in accordance with the provisions of Section 160, since if this has not been done his appointment will be invalid.

It has already been pointed out that professional etiquette requires that the retiring auditor be approached to ascertain whether, in his opinion, any

reasons exist which would make it undesirable or improper for the office to be accepted by the new nominee.

In the case of a casual vacancy in the office of auditor, occasioned either by the death or retirement of the auditor during his term of office, the directors have power to appoint a new auditor, and the auditor so appointed should obtain a copy of the directors' minute appointing him.

(b) The Remuneration of the Auditor.

The amount of the auditor's fee is generally based on the time which the audit is estimated to occupy, regard being had to the responsibility involved. The auditor is usually asked to quote a fee for which he will be willing to perform the audit, but it is sometimes very difficult to do this with any degree of accuracy, and where the auditor is appointed by the directors before the first annual general meeting, an arrangement is frequently made whereby the remuneration is agreed upon with the directors after the audit is completed.

In succeeding years the remuneration is voted either in advance or retrospectively by the company at the time of the reappointment of the auditor, whilst in some cases a resolution is passed authorising the directors to agree the remuneration with the auditor.

As has already been stated, unless the auditor's remuneration has been fixed by the members in general meeting, the amount thereof must be shown separately in the company's Profit and Loss Account. For this purpose the term remuneration includes the auditor's expenses.

In cases where the books of the company are not balanced prior to the audit, or where draft accounts are not prepared by the company's officials and presented to the auditor, he should make it clear to the directors that it is no part of his duty to perform work of this nature, and if it is desired that he should do this, it will be in his capacity as accountant. A separate fee should be arranged for additional work of this kind.

(c) Inspection of Books and Documents.

In addition to obtaining a list of all the books in use and inspecting these, the auditor should examine the following documents :—

(1) *The Memorandum and Articles of Association.*

The auditor should peruse the Memorandum, and particularly the objects clause, since occasionally the question may arise whether certain transactions are *intra vires* the company. If transactions have been entered into which are not within the scope of the objects clause, the auditor should draw attention to the facts in his report to the members. Owing to the comprehensive nature of most objects clauses, however, this contingency rarely arises.

The Articles of Association call for careful scrutiny by the auditor upon his appointment, and special attention should be paid to the following points :—

(*a*) The regulations as to the issue of capital, payment of underwriting commission, etc.

(*b*) Making calls, interest on calls in arrear, and on calls paid in advance.

(*c*) Forfeiture and lien.

(*d*) Directors : Their number, remuneration, qualification, disqualification and removal.

(*e*) Appointment and powers of managing directors.

(*f*) Proceedings and powers of the Board.

(*g*) Dividends and reserves.

(*h*) Extent of borrowing powers.

(*i*) Rights of members *inter se.*

Any Special Resolutions passed subsequently which alter any provision of the Articles should also be carefully noted.

(2) *The Prospectus.*

Where a Prospectus has been issued, the auditor should examine this, with particular reference to the following points :—

(*a*) The amount of capital proposed to be issued, the different classes of shares to which it relates, and the rights of members *inter se.*

(*b*) Whether the issue is in respect of redeemable preference shares, or of shares being issued at a discount.

(*c*) The qualification and remuneration of directors.

(*d*) The minimum subscription, and the amounts payable on application and allotment; also the dates fixed for future calls, and the amounts thereof, if any.

(*e*) Particulars of any contract entered into with the vendors for the purchase of any property, and the amount payable in cash, shares or debentures in respect of such purchase consideration. The amount, if any, payable for goodwill must be specified separately.

(*f*) The amount payable for underwriting commission, or for commission on placing shares or debentures. The rate of commission in respect of shares must not exceed 10 per cent. of the issue price, or such lower rate as may be allowed by the Articles.

(*g*) The amount, or estimated amount, of preliminary expenses.

(*h*) Particulars of any material contracts entered into.

(3) *Contracts.*

The auditor should examine all contracts with vendors or other persons relating to the purchase of property, payment of commission, or preliminary expenses.

(4) *Balance Sheet, Accounts and Reports.*

Except in the case of a new company, the auditor should examine the last Balance Sheet and Accounts, as these will contain the opening entries for the period under review.

The late auditor's report should be examined, as this may contain material information of which it is important the new auditor should be aware.

The last report of the directors to the members should be seen, as this will contain the recommendations of the directors in respect of the appropriation of the previous year's profits. The members' minute book should be examined, in order to ascertain whether such recommendations have been carried out.

It is the usual practice for the auditor to make a record of the information he has obtained with regard to the books, documents and other matters set out

above. These constitute what are known as permanent audit notes, which are kept separate from the notes relating to the annual audits, and obviate constant reference to the documents themselves. It is of the greatest importance that these notes should be kept up-to-date.

§ 2.—Share Capital.

(a) The Various Classes of Share Capital.

The share capital of a company is frequently divided into different classes, of which the following are the most usual:—

(1) *Preference Shares.*

Preference Shares may be either *cumulative* or *non-cumulative.* The latter only carry a right to a fixed dividend out of the profits of any year, and if there are insufficient profits in that year to pay the full amount of dividend, they have no right to have such arrears made up out of future profits. They may or may not have a right to repayment of capital in priority to other classes of shares in the event of liquidation.

Cumulative preference shares entitle the holders to a fixed rate of dividend in the same way as non-cumulative preference shares, but with the additional right that any arrears of dividend shall be made up out of future profits, in priority to any dividends on other classes of shares.

The rights of preference shareholders are governed by the Memorandum and Articles of Association, and there are other varieties than the two enumerated above; such as, for example, participating preference shares, which have a right to further dividends after the ordinary shares have received a certain rate per cent.

Where it is stated that preference shares are entitled to a preferential dividend at a specified rate per cent., such dividend is *primâ facie* cumulative (*Webb* v. *Earle*, 1875, 20 Eq. 556; *Henry* v. *Gt. N. Rly. Co.*, 1 de G. & J. 606; *Foster* v. *Coles and M. B. Foster & Sons*, 1906, W. N. 107). If the intention is that the preference shares should be non-cumulative, the clause defining their rights must clearly express this. A declaration that the preference dividend is to be paid out of the profits *of each year*, has been interpreted as not giving cumulative rights (*Staples* v. *Eastman Co.*, 1896, 2 Ch. 303).

In the absence of specific provision, preference shares entitled to a fixed cumulative dividend are not entitled to share in any surplus profits after such dividend has been paid (*Will* v. *United Lankat Plantations Co.*, 1914, 83 L. J. Ch. 195).

A preference shareholder is not entitled to preference in respect of return of capital, unless specific rights are attached in this connection (*London India Rubber Co.*, 1866, 5 Eq. 519).

Unless the Memorandum or Articles provide to the contrary, preference shares having a right to repayment in priority to ordinary shares are entitled to share *pro rata* with the ordinary shares in the distribution of any surplus assets after the ordinary shares have been repaid (*In re Espuela Land & Cattle Co.*, 1909, 78 L. J. Ch. 729; *In re Fraser & Chalmers Ltd.*, 1919, 88 L.J. Ch. 343; *Anglo-French Music Co.* v. *Nicholl*, 1921, 90 L.J. Ch. 183; *William Metcalf & Sons*, 1932, W.N. 205). The terms of issue, and the provisions of the Memorandum and Articles must, however, be considered carefully.

The rights of preference shareholders to the payment of arrears accumulated on preference dividends, in the event of liquidation, are discussed in Chapter VIII, § 5 (*d*).

(2) *Redeemable Preference Shares.*

Redeemable preference shares may be issued in accordance with the provisions of Section 58 of the Companies Act, 1948, subject to authorisation by the Articles. The redemption can only be effected out of profits available for dividends or out of a fresh issue made for the specific purpose. The shares cannot be redeemed unless they are fully paid. When the shares are redeemed out of divisible profits, a sum equal to the nominal value of the shares redeemed must be transferred to a " Capital Redemption Reserve Fund," which for the purposes of the provisions of the Act relating to the reduction of share capital must be regarded as if it were paid-up share capital of the company. Any premiums payable on redemption must be provided out of profits or out of any share premium account before the shares are redeemed.

Where shares are redeemed out of the proceeds of an issue made for the specific purpose, no additional *ad valorem* duty will be payable on the new issue, if the redemption is effected within one month after such new issue.

The redemption of preference shares is not to be taken as reducing the amount of the company's authorised capital.

The Capital Redemption Reserve Fund may be applied in paying up unissued shares of the company to be issued as fully paid bonus shares to the members.

(3) *Ordinary Shares.*

Ordinary shares are those taking the surplus profits remaining after satisfaction of prior interests (if any).

These may be divided as between preferred and deferred ordinary shares, the former having a preferential right to a fixed rate of dividend over the latter, while the latter frequently have a right to the whole, or a proportion of the surplus profits after the provision of dividends on other classes of shares.

(4) *Founders' or Deferred Shares.*

Founders' or *deferred* shares are usually limited in number and of small nominal value. They are generally issued fully paid to the original vendors or their nominees, in consideration either of part of the purchase price or of services connected with the formation of the company. Generally, they only rank for dividend after other classes of shares have received certain rates of dividend, when they are entitled to the whole or a portion of the surplus profits. In some instances shares of this nature are termed *management shares.*

Holders of founders' shares may be inclined to call for their maximum dividend in prosperous years, with the result that the company may not transfer adequate amounts to reserve for the purpose of equalising dividends in future years, or strengthening its general financial position; but usually the directors have power to put profits to reserve before the payment of any dividend, and where this is so, they can place so much of the profits of any year, as they think fit, to reserve, even though this may have the effect of preventing the payment of any dividend on the founders' shares (*Fisher* v. *Black & White Publishing Co.*, 1901, 1 Ch. 174).

(5) *The Distinction between Stock and Shares.*

The chief differences are as follows :—

(*a*) Stock must be fully paid up ; whereas shares need only be partly paid up.

(*b*) Stock may be issued or transferred in fractional parts ; a fraction of a share cannot be transferred.

Under Section 61 of the Companies Act, 1948, a company can by an ordinary resolution convert all or any of its paid up shares into stock, and reconvert that stock into paid up shares of any denomination.

The issued capital of a company other than capital represented by shares whose rights to participation in profits and capital are restricted is known as the equity share capital.

In the majority of cases, the equity share capital is represented by ordinary shares, but where there are deferred or founders' shares and the participation in profits of ordinary shareholders is limited, it will be the deferred or founder shareholders who have the equity.

(b) Shares issued for Cash.

In order to vouch shares issued for cash, the following procedure will be necessary :—

(1) Check the applications with the Application and Allotment Books.

(2) Check the shares allotted, and the amounts payable on application and allotment, from the Application and Allotment Books into the Share Ledger.

Reference should be made to the Register of Split and Renounced Allotment Letters, as the names of the original allottees may

in many cases not be the same as those ultimately entered in the Share Register.

(3) Check cash received on application and allotment with the Pass Book; check the Shareholders' Cash Book in detail into the Share Ledger, and in total into the Application and Allotment Accounts.

(4) Where applications have been returned owing to allotment not being made, vouch repayment of cash with the Application and Allotment Book.

(5) Examine the Minute Book to see that all allotments have been made the subject of a minute, and where only the total number of shares allotted on any day is referred to in the minutes, see that the Application and Allotment Book has been initialled by a director up to the point referred to in the minutes.

(6) Similar procedure should be adopted to verify the proceeds of calls.

(7) See that the issue is within the limits authorised by the Memorandum and Articles of Association.

(8) See that the provisions with regard to the minimum subscription have been complied with.

(9) Vouch the Journal entries relating to the issue of shares, and check the postings.

(10) Check the balances on the Share Ledgers, and see that the total agrees with the total capital issued.

(11) Check the balances on the shareholders' cash accounts in the Share Ledger, and see

that they agree with the balances shown as outstanding on the Application and Allotment and call accounts.

If it was stated in the prospectus that application had or would be made for permission to deal in the shares on any Stock Exchange, see that—

(12) All money received on application is kept in a separate banking account so long as liability to refund such money exists.

(13) Permission to deal has been granted by the Stock Exchange or, if this has been refused, that application monies have been repaid to the applicants.

(c) Issue of Share Warrants to Bearer.

The company may have issued share warrants to bearer under the provisions of its Articles, and in accordance with Section 83 of the Companies Act, 1948. Such warrants can only be issued in respect of fully-paid shares. A private company cannot take power to issue such warrants as, since they are transferable to bearer, there can be no effective restriction on delivery. The auditor should check the cancelling entries in the Share Ledger with those in the Register of Share Warrants, and the aggregate of the balances on both should be agreed with the total of the issued share capital.

(d) Shares issued for Consideration other than Cash.

The issue of shares to a vendor in part payment of the purchase consideration will be vouched by reference to the contract between the company and the vendor, and the minutes recording the allotment. Such contracts must be filed with the Registrar of Companies within one month after allotment, and the auditor should ascertain whether this has been done

Where the contract has not been reduced to writing, particulars of it must be filed, duly stamped. The effect of non-registration of a contract, or of particulars thereof in the circumstances mentioned, within the prescribed period or such extended time as may be allowed by the Court, is the liability to a penalty of £50 a day during which the default continues, on every director or other officer who is knowingly a party to the default, but the title of the allottee is not affected so long as the contract itself is valid.

Frequently shares are issued to the nominees of the vendor, either by virtue of a supplementary agreement or under a written nomination by the vendor in favour of his nominees. The issue of such shares will be vouched by reference to these documents.

Shares are sometimes issued as fully paid to persons in consideration of the payment by them of part or the whole of the preliminary expenses of the company; the issue of such shares will be vouched in the same manner as the vendor's shares.

Payment of underwriting commission, or commission on placing shares, is usually made by cash, but is sometimes discharged by the issue of fully paid shares. The auditor's duties in connection with the vouching of payments of this nature are considered in Section 6, and assuming the issue of such shares to be in order, the vouching of the issue will be carried out in the same manner as that above described.

The auditor should vouch the journal entries relating to shares issued for consideration other than cash with the contracts and the minute book. The shares allotted should be checked into the share ledger.

Shares are sometimes issued to vendors or others partly paid in part consideration of the purchase price. This particularly applies in reconstructions where further capital is required, and shares in the new company are issued partly paid to the members of the old company.

(e) Shares issued at a Premium.

Shares may be issued at a premium, and the auditor should see that the amount received in respect of the premium is placed to the credit of a Share Premium Account, which must be shown as a separate item in the Balance Sheet.

Under the provisions of Section 56, Companies Act, 1948, the balance on the Share Premium Account may only be used for the following purposes :—

(*a*) In paying up unissued shares of the company to be issued to the members as fully paid bonus shares.

(*b*) To write off preliminary expenses.

(*c*) To write off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures.

(*d*) In providing for the premium payable on redemption of any redeemable preference shares or of any debentures.

The above provisions apply equally to premiums received prior to the passing of the Companies Act, 1948, in-so-far as it is still possible to identify such premiums.

(f) Shares issued at a Discount.

Power to issue shares at a discount was first given by the Companies Act, 1929. The right to make

an issue on such terms is rarely exercised in practice, because the mere fact that the shares are to be issued at less than par casts doubt on their true value and acts as a deterrent to the potential investor.

The conditions imposed by Section 57, Companies Act, 1948, must be complied with if shares are to be issued at a discount. These conditions are:—

(1) The new issue must be of a class of shares already issued.

(2) The issue must be authorised by ordinary resolution of the company, *and sanctioned by the Court.*

(3) The resolution must specify the maximum rate of discount at which the shares are to be issued.

(4) There must have been an interval of at least one year between the date upon which the company was entitled to commence business, and the issue of the shares.

(5) The shares must be issued within one month after the date on which the issue was sanctioned by the Court, or within such extended time as the Court may allow.

(6) Every prospectus of the issue must show particulars of the discount or so much as has not been written off at the date of the prospectus.

Every Balance Sheet subsequently issued must show as a separate item the amount of discount not written off to date.

Where shares have been so issued, it will therefore be the duty of the auditor to ascertain that due effect has been given to the statutory provisions. There

does not appear to be any obligation to write off the discount, but the same principles will apply to this item as to preliminary expenses, underwriting commission, etc., and it is advisable that provision should be made for the elimination of the item over a short period of years.

(g) Share Books.

Under Section 110 of the Companies Act, 1948, every company is obliged to keep a Register of Members, and sometimes the Share Ledger is so arranged as to fulfil the requirements of this section. In some cases a Register of Transfers is kept, recording particulars of all transfers registered by the company, but this book is frequently dispensed with, and the entries made direct from the transfers into the Share Ledger, unnecessary duplication thus being avoided.

The question as to how far it is the duty of the auditor to examine these books, on the occasion of each audit, is important. It has already been stated that on the occasion of any issue of share capital, the auditor should check the entries relating thereto into the Share Ledger. His duty is to report upon the Balance Sheet and Profit and Loss Account of the company, and, in order to ascertain that the issued capital as stated therein is correct, he must vouch such issue in detail; but once this has been done, it is immaterial to the auditor whether the capital is held by one or another individual member and he need not, therefore, check share transfers in detail. He should, however, check the balances on the Share Ledger on the occasion of each audit, and see that the total agrees with the issued capital as shown in the Balance Sheet, since if shares had been fraudulently issued and entered in the Share Ledger, the auditor

might be held responsible if he failed to discover the fraud, owing to his omission to check the balances on this book.

When the transactions in the shares of a company are numerous, the receipts from transfer fees will be a considerable item. In any case these receipts must be vouched by the auditor, either by reference to the Transfer Register or by counting the transfers.

(h) Share Transfer Audit.

It does not form part of the auditor's duties in the ordinary course to check the share transactions in detail, but he is frequently employed by the directors to perform this work at a special fee. Such an audit is termed a Share Transfer Audit, and its object is the prevention of clerical errors, and of the issue of duplicate share certificates or certified transfers, whether fraudulently or otherwise. The necessity for such an audit has often been emphasised, particularly where the duties of registrar for groups of companies are carried out by a separate company under the control of the dominant directors of the groups. The Council of the London Stock Exchange regard a share transfer audit as so desirable that the method adopted by each company is noted in the *Stock Exchange Official Intelligence.*

The auditor should ascertain that all transferors have been notified of the lodgment of transfers, and enquire as to whether any objections have been received. The transferors' signatures should be examined with previous transfers or application forms, and it should be seen that the transfers are duly executed and stamped. The distinctive numbers of the shares, if any, should be checked, with the transferors' account

in the Share Ledger and with the certificate lodged with the transfer, which should be cancelled. Where part of the holding comprised in a certificate is transferred, it is sometimes the practice to issue balance certificates, when it should be seen that the number of shares thereon represents the balance of shares not transferred. An alternative method is to indorse the shares transferred on the back of the original certificate. The new certificates and balance certificates (if any) should be checked and initialled by the auditor, and it should be seen that the counterfoils thereof are correctly entered. The entries in the Transfer Register, if any, should also be checked.

On the occasion of his next visit the auditor should examine the Minute Book to ascertain whether the Board have passed all transfers previously examined by him, and, if so, he should check the entries from the Transfer Register, or from the transfers themselves, to the Share Ledger.

(i) Forged and Blank Transfers.

When a company certifies a transfer, such certificate may be taken as a representation by the company to any person acting on the faith of the certificate that there have been produced to the company such documents as *primâ facie* show the transferor to have a title to the shares or debentures which are the subject of the transfer. The certificate is not, however, a representation that the transferor has, in fact, a title. If any person acts on the faith of a false certification which has been made by the company negligently, the company will be under the same liability to such person as if the certification had been made fraudulently (Section 79, Companies Act, 1948).

Under Section 117 of the Companies Act, 1948, no notice of any trust may be entered on the register; but if the directors are aware that a transfer is being made in breach of trust or for the purpose of defrauding any person having equitable rights in the shares, they may become personally liable if they pass the transfer without notifying the person interested, although the company is under no liability (*Société Générale* v. *The Tramways Union*, 1885, 14 Q.B.D. 424).

Blank transfers are frequently deposited by way of security for an advance, accompanied by a share certificate. The transfer is signed by the transferor, but the name of the transferee and the date of execution are not inserted until it is desirable to register the transfer.

Where the regulations of the company do not require that the transfer shall be by deed, it may be effected by writing under hand, *i.e.*, by mere signature of the parties to it; and in the case of a blank transfer, if the holder improperly fills in his own name, the title in the shares does not pass. If the transfer is passed on in blank to another person, who subsequently fills it up, the latter can only claim the same rights as the original holder, since the fact that he received the transfer in blank was equivalent to notice that an absolute sale had not been effected (*France* v. *Clark*, 1884, 26 Ch. 257; *Fox* v. *Martin*, 1895, W.N. 36).

Where the holder of a blank transfer, acting improperly, inserts the name of the transferee, and such transferee takes the shares for proper consideration and without notice of any fraud or irregularity, his title is valid against the original holder (*Sheffield* v. *London Joint Stock Bank*, 1888, 13 A.C. 333; *London Joint Stock Bank* v. *Simmonds*, 1892, A.C. 201); but

until the title of such purchaser is completed by registration, the title of the true owner holds (*Ireland* v. *Hart*, 1902, 1 Ch. 522). A blank transfer cannot, therefore, be said to afford absolute security to the holder.

If the transfer is required to be by deed, the document is not complete until the transferee's signature and date of execution are inserted, so that although it may give the transferee an equitable title, it does not give a legal title. Any alteration of the transfer renders it void as a deed unless such alteration is made with authority under seal or the transfer is redelivered by the transferor (*Ireland* v. *Hart*, 1902, 1 Ch. 522; *Société Générale* v. *Walker*, 1886, 11 A.C. 20).

If the transferor, for the purpose of defrauding the holder of the blank transfer, executes another transfer, such transferee will have a good title to the shares on registration of his transfer, and the blank transfer may be defeated (*Peat* v. *Clayton*, 1906, 1 Ch. 659).

The fact that most companies note on their share certificates that no transfer will be registered without production of the certificate, does not apparently prevent a company issuing duplicate certificates in place of those lost or defaced, and most companies take power under their Articles to issue such duplicates, a letter of indemnity from the holder usually being required. It would not be a difficult matter for the transferor who has signed a blank transfer and deposited his share certificate as security for an advance, to obtain from the company a duplicate certificate, under a misrepresentation that he had lost his original certificate, and then to execute a fresh

transfer, selling the shares on the faith of the duplicate certificate so issued.

Persons lending money on the security of share certificates or certified transfers should, therefore, to prevent the possibility of loss, take immediate steps to have the transfers completed, and registered in the names of themselves or their nominees. Alternatively, they may serve upon the company a notice in lieu of distringas. When such a notice is served, the company cannot transfer the stock or shares without giving eight days' notice to the mortgagee or other person filing the affidavit, within which time an injunction can be applied for to restrain the transfer.

(j) Forfeited Shares.

If any shares have been forfeited, the auditor should examine the minutes dealing with the matter and ascertain that due notice of forfeiture has been given to the member, in accordance with the articles or the provisions of Table A. The Articles of a company usually lay down the procedure to be followed, and the rights and liabilities of the member whose shares have been forfeited. It is common to find that the member whose shares have been forfeited is made liable for all calls made prior to forfeiture. It is, however, not usual to treat such calls as in arrear, and only the actual cash received on account of the forfeited shares is placed to the credit of the Forfeited Shares Account. This should be shown separately in the Balance Sheet, until the shares have been re-issued, when, if the total amount received in respect of the shares is more than the nominal value thereof, the final balance standing to the credit of the Forfeited Shares Account should be transferred to the Share Premium Account. It must

not be taken to the credit of the Profit and Loss Account.

(k) Calls Paid in Advance.

Directors may receive moneys from shareholders in advance of calls. Under Table "A" power is given to pay interest at a rate not exceeding 5 per cent. on amounts so advanced, and such interest is a charge against the profits, but can be paid out of capital. Calls paid in advance do not strictly form part of the share capital, and should be shown separately in the Balance Sheet. In the event of winding-up, they are repayable with interest before any return is made in respect of called-up capital (*In re Wakefield Rolling Stock Co.*, 1892, 3 Ch. 165).

(l) Interest Payable out of Capital during Construction.

Under Section 65 of the Companies Act, 1948, where shares are issued for the purpose of raising money for the construction of works, buildings, or plant which cannot be made profitable for a lengthened period, a company may pay interest at the rate of 4 per cent. per annum, or at such other rate as may be prescribed by order of the Treasury, on so much of such capital as is for the time being paid up, and charge such interest to capital as part of the cost of construction. (The maximum rate which can at present be paid is six per cent. (Companies (Interest out of Capital) Order, 1929.)) The payment must be authorised by the Articles or by special resolution, and must receive the previous sanction of the Board of Trade. The payment must not extend beyond the close of the half-year next after the half-year during which the works or buildings have been actually completed or

the plant provided. The accounts of the company must show the share capital on which, and the rate at which, interest has been paid out of capital.

Interest on debentures issued for a similar purpose can be charged to capital during the period of construction (*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, 1906, 2 Ch. 654).

(m) Alteration of Rights of Members.

The rights attaching to any class of shares may be altered in accordance with power which may be contained in the Memorandum, subject to the provisions of Section 22 as to the rights of minorities, or alternatively under Section 206 of the Companies Act, 1948, when a compromise or arrangement is proposed.

The auditor should satisfy himself that the appropriate resolution has been duly passed, and that, where required, the approval of the Court has been obtained. This will enable him to vouch the necessary journal entries recording the alteration. Where the scheme involves an alteration in the number of shares held by each member, or in the nominal amount of such shares, or the conversion of one class of shares into another class, the auditor should check the necessary entries in the books and also the alterations in the Share Ledger. It should be ascertained that the requisite steps have been taken either for new share certificates to be issued, or for a slip to be supplied to each member concerned for attachment to his certificate.

(n) Increase or Reduction of Capital.

An increase of capital, if authorised by the Articles, may be effected by an ordinary resolution of the company (Section 61).

A reduction of capital must be in accordance with the provisions of Sections 66-71 of the Act. Power which is exercisable by a special resolution, must be contained in the Articles and the sanction of the Court must be obtained.

The auditor must therefore satisfy himself that the statutory procedure has been properly carried out, that due effect has been given thereto in the books of account, and, in the case of reduction, that the necessary alterations have been made in the Share Ledger. The share certificates would require correction, and although the auditor could scarcely be regarded as responsible for this, it would be advisable for him to see that proper steps have been taken to this end.

Where effect has been given to the resolution to increase the capital of the company, the procedure outlined in § 2 (*b*) of this chapter would be followed.

§ 3.—The Prospectus.

Where a company seeks to obtain the whole or part of its capital by public subscription, a prospectus must be issued, the preparation of which is a matter for the promoters or directors, and the auditor is under no responsibility should any of the statutory information be excluded, or statements appear therein which are afterwards discovered to be unfounded (except, of course, statements included in his own report).

An auditor does not sustain liability by merely permitting his name to be mentioned in the prospectus as auditor, or by merely permitting a professional report made by him to be referred to in it; or by merely preparing or advising upon it, or assisting in its preparation professionally.

Where a public company does not issue a prospectus, it must file with the Registrar of Companies *a statement in lieu of prospectus* in the form and containing the particulars prescribed by the Fifth Schedule to the Companies Act, 1948.

The Companies Act, 1948 (Fourth Schedule, Parts II and III), requires that the prospectus shall contain a report by the auditors of the company with respect to :—

(1)—(*a*) profits and losses and assets and liabilities, in accordance with sub-paragraph (2) or (3) of this paragraph, as the case requires ; and

(*b*) the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the five financial years immediately preceding the issue of the prospectus, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years ;

and, if no accounts have been made up in respect of any part of the period of five years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

(2) If the company has no subsidiaries, the report shall—

(*a*) so far as regards profits and losses, deal with the profits or losses of the company in respect of each of the five financial years immediately preceding the issue of the prospectus ; and

(*b*) so far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up.

(3) If the company has subsidiaries, the report shall—

(*a*) so far as regards profits and losses, deal separately with the company's profits or losses as provided by the last foregoing sub-paragraph, and in addition, deal either—

(i) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the company ; or

(ii) individually with the profits or losses of each subsidiary, so far as they concern members of the company ;

or, instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries; and

(*b*) so far as regards assets and liabilities, deal separately with the company's assets and liabilities as provided by the last foregoing sub-paragraph and, in addition, deal either—

(i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or

(ii) individually with the assets and liabilities of each subsidiary;

and shall indicate as respects the assets and liabilities of the subsidiaries the allowance to be made for persons other than members of the company.

Where a business is to be bought directly or indirectly out of the proceeds of the issue, accountants, who must be named in the prospectus, must report upon—

(*a*) the profits or losses of the business in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(*b*) the assets and liabilities of the business at the last date to which the accounts of the business were made up.

If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and if by reason of that acquisition or anything to be done in consequence thereof or in connection therewith that body corporate will become a subsidiary of the company, the prospectus must contain a report by accountants named therein upon—

(i) the profits or losses of the other body corporate in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(ii) the assets and liabilities of the other body corporate at the last date to which the accounts of the body corporate were made up.

The said report shall—

(*a*) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired; and

(*b*) where the other body corporate has subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-paragraph (3) of paragraph 19 of this Schedule in relation to the company and its subsidiaries (Fourth Schedule Part II).

The reports to be made by accountants named in the prospectus must be made by accountants who are qualified under the Act to be auditors of a company other than an exempt private company, and such accountants must not be officers or servants or partners of or in the employment of officers or servants of the company or of the company's subsidiary or holding company or of a subsidiary of the company's holding company. The term "officer" for this purpose includes a proposed director but not an auditor.

The accountant giving the report referred to above is an expert within the meaning of Section 40, Companies Act, 1948, and the prospectus may not be issued until he has given his written consent to the issue thereof, and a statement that he has given and has not withdrawn his consent appears in the prospectus. This provision does not apply to the auditor of the company issuing the prospectus in regard to his report on the profits, etc., of that company.

Where a statement in lieu of prospectus is filed, if it is proposed to use any unissued shares or debentures of the company for the purchase of a business, the statement must contain a report by accountants named therein, in the same form as would be required in a prospectus. It is not necessary to include in a statement in lieu of prospectus a report by the auditors of the company as to the profits, etc., of that company.

If the person making the report upon profits or losses and assets and liabilities considers it necessary to make any adjustments therein, the report must either indicate by way of a note the adjustments required, or the adjustments may be made and the report state that they have been made.

Further consideration of the adjustments which would be customary in such circumstances has been given in Chapter XIV on "Investigations."

It cannot be too strongly emphasised that an auditor should refrain from giving any estimate as to future profits, or offering any opinion as to the prospects of the company; his duty is confined to facts as required by statute.

§ 4.—Mortgages.

A *mortgage* is a transfer of an interest in property for the purposes of securing repayment of a loan with interest at a given rate. Until default is made in the terms of the deed, either as regards the payment of interest or repayment of principal, or in any other way, the mortgagor (*i.e.*, the borrower) retains possession and use of the property, and the mortgagee (the lender) has no right to deal with it.

Mortgages affecting the property of the company, as defined in Section 95 of the Companies Act, 1948,

must be registered with the Registrar of Companies in the same manner as in the case of debentures referred to, *post*.

The auditor should vouch the receipt of the loan, and examine the Register of Charges in which particulars of the loan must be inserted under Section 104 of the Companies Act, 1948. In the Balance Sheet the loan should be shown separately on the liabilities side, the fact that it is secured being duly noted.

§ 5.—Debentures.

(a) Definition of Debenture.

A *debenture* is a written acknowledgment under seal of a debt due by a company, containing provisions as to payment of interest and repayment of principal. It may be either a simple or naked debenture, carrying no charge, or a debenture carrying either a fixed or floating charge on some or all of the assets of the company, either including or not, as the case may be, the uncalled capital of the company.

Under Section 95 of the Companies Act, 1948, all mortgages and charges affecting the property of the company, as defined in that section, must be registered within 21 days after the date of creation, with the Registrar of Companies, otherwise they will be void against the liquidator and any creditor of the company, so far as the security comprised by the charge is concerned. If so rendered void, the principal moneys will immediately become repayable.

Under Section 104, the necessary entries must be made in the Register of Charges kept by the company.

Debentures either take the form of bonds to bearer, or they may be registered in the names of the holders, transmission being by transfer. In the latter

case, although there is no direct statutory obligation to do so, it is usual to keep a Register of Debenture Holders.

Debenture stock may also be issued, the distinction between debentures and debenture stock being similar to that between shares and stock. Usually, debenture bonds cannot be divided and must be transferred entire; but debenture stock can be transferred in whole or in part, subject to any fractional limitations imposed at the time of issue.

On the issue of a series of debentures by a company, it is usual for two or more persons or a trustee corporation to be appointed as trustees for the debenture holders for the purpose of acting generally on their behalf. Where this is the case, a fee is usually payable by the company to the trustees for their services.

(b) Issue of Debentures.

Where a series of debentures is issued, the procedure is similar to that in the case of an issue of shares, and the work to be performed by the auditor in vouching the issue will be of the same character.

When debentures are issued for cash, the receipt of the cash must be vouched. Frequently debentures are issued to vendors of the business as fully paid in part payment of the purchase consideration, and in such cases the auditor must examine the contracts under which the issue is made.

The auditor should examine a copy of the debentures, or the trust deed under which they are issued, in order to ascertain the terms and conditions of issue.

The Memorandum and Articles of Association should be examined to ascertain the borrowing powers of the company. Where no such provision is made,

a company has no power to borrow unless such borrowing can be regarded as properly incidental to the carrying on of the business. A trading company has an implied power to borrow and give security, even without any specific powers to do so (*General Auction Estate Co.* v. *Smith*, 1891, 3 Ch. 432).

Under Clause 79 of Table "A" directors may exercise all the powers of the company to borrow money and they may mortgage or charge the undertaking, property and uncalled capital of the company or any part thereof. The clause also gives the directors power to issue debentures, debenture stock and other securities whether outright or as security for any debt, liability or obligation of the company or of any third party. The amount so borrowed by the directors by virtue of this power must not without the previous sanction of the company in general meeting exceed the nominal amount of the company's share capital for the time being issued. In calculating this maximum, however, temporary loans obtained from the company's bankers in the ordinary course of business need not be taken into consideration.

Where a company has no borrowing powers, or where the Memorandum fixes a limit, any loan in the first case, or any loan in excess of the limit in the second, is *ultra vires* the company. It is, in consequence, absolutely void, and any securities given are inoperative (*Howard* v. *Patent Ivory Co.*, 1888, 38 Ch. D. 156). If the loan is *ultra vires* the directors it is invalid, and the securities given are inoperative, except in-so-far as the company is estopped from denying its validity under the rule in *Royal British Bank* v. *Turquand* (1857, 6 E. and B. 327). This

rule is that persons dealing with a company are not bound to enquire whether all the necessary steps have been taken so long as the particular act appears to conform to the provisions of the Memorandum and Articles. Thus, for example, if a company may only borrow up to a limit of £2,000 without the prior consent of the members in general meeting, a *bonâ fide* lender may lend £2,000 without enquiring if there are other loans outstanding. If other loans are outstanding, the company is estopped from denying the validity of this loan. Where directors have acted *ultra vires* their borrowing powers, the company may elect to ratify their acts (*Irvine* v. *Union Bank of Australia*, 1877, A.C. 366). An overdraft at a bank must be taken into account where limited powers of borrowing are involved (*Looker* v. *Wrigley*, 1880, 9 Q.B.D. 397).

Uncalled capital reserved under Section 60 of the Act, which cannot be called up except in the event of, and for the purposes of liquidation, cannot be made the subject of a charge (*Bartlett* v. *Mayfair Property Co.*, 1898, 2 Ch. 28).

The practice of creating a floating charge after it is known that the company is insolvent, and immediately prior to the company going into liquidation, for the purpose of securing an already existing debt, is defeated by Section 322. Under this section every floating charge, if created within twelve months of the commencement of winding-up, unless it is proved that the company immediately after the creation of the charge was solvent, is invalid, except as to the amount of any cash paid to the company at the time of, or subsequent to the creation of, and in consideration for, the charge, together with interest on that amount

at the rate of 5 per cent. per annum or such other rate as may be prescribed by the Treasury.

The auditor should ascertain that the debentures have been duly registered with the Registrar of Companies, and should examine the entries relating thereto in the Register of Charges.

Debentures may be issued at par, at a discount, or at a premium ; and may be repayable at par or at a premium. Special points arise in each case, which demand consideration :—

(1) *Debentures issued at a Premium.*

Although the Companies Act, 1948, does not prescribe the manner in which premiums received on an issue of debentures should be dealt with, it is considered that they should be regarded as capital profits and classified in the Balance Sheet as a capital reserve. Alternatively, they may be utilised to form the nucleus of a Debenture Redemption Fund; or, if not employed in this manner, they may be used to write off fictitious assets. It is usual to charge the expenses of issuing the debentures against the premium received.

In the Balance Sheet the debentures will appear as a liability at their *nominal* value.

(2) *Debentures issued at a Discount.*

Debentures can be issued at a discount, and the discount can be regarded as a lump sum allowance to the lenders when taking up the debentures, in consideration of their accepting a lower rate of interest than would have been payable had the debentures been issued at par. The financial position

of the company and the state of the money market at the date of issue are important factors in determining the price of issue.

The debentures will appear in the Balance Sheet as a liability at their *nominal* value, and the discount will be written off over a period of years, the balance remaining at any date being carried forward as a separate item in the Balance Sheet. Any sums paid by way of commission in respect of the issued debentures, or allowed by way of discount, must be stated in the Annual Summary.

As this discount does not represent an available asset, it is very advisable that it should be written off as soon as possible. It cannot be said, however, to be incorrect to write off the discount over the term of the debentures; and in that case, when no sinking fund is formed for the purpose of repaying the debentures, and the debentures are repayable at the end of a given period, an equal amount of the discount should be written off each year. If the debentures are repayable by annual drawings, without the provision of a sinking fund, the discount should be written off in relative proportion to the amount of debentures outstanding each year, in order that the periods enjoying the use of the greater portion of the debentures should be charged with the greater portion of the discount.

Where the redemption of the debentures is provided for by annual charges against Profit and Loss Account, such charges will include provision for the discount, and, consequently, the discount can be written off against the credit balance of the Redemption Account, when the debentures have been redeemed.

(3) *Debentures repayable at a Premium.*

These debentures will appear in the Balance Sheet as a liability at their nominal amount, with a note of the amount at which they are repayable, any discount or premium on issue being treated in one of the ways described above.

If a sinking fund is formed to provide for repayment, this should include provision for the payment of the premium on redemption. If no sinking fund is formed, the premium should be provided for out of profits over the term of the debentures.

(4) *Debentures issued as Collateral Security for a Loan.*

It is a common practice for companies to issue debentures as collateral security against a loan or overdraft from a bank or other parties. Section 90 (3) of the Companies Act, 1948, expressly refers to this procedure, and provides that such debentures shall not be deemed to have been redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remained so deposited.

The term collateral security means a security which can be realised by the party holding it, in the event of the original loan in respect of which the security was given not being repaid at the proper time, or in any other specific cases, according to the agreement between the parties. As soon as the loan is repaid, the collateral security is automatically released.

When debentures are issued in this manner, they should be shown *in short* in the Balance Sheet, and stated as having been issued as collateral security. The loan against which they are issued will be extended as a liability in the usual way.

(c) Redemption of Debentures.

Debentures may be redeemable according to the terms of issue, at specified dates, by annual or other drawings, or at the option of the company, after due notice has been given of intention to repay.

The auditor should examine the provisions of the trust deed, or the debenture bonds, relating to the redemption, and ascertain that they are duly complied with.

Where the debentures are redeemable at the end of a given period, it is usual to find provision made in the trust deed for a sinking fund to be raised out of profits for the purpose of redemption.

The operation of such a fund entails a charge against Profit and Loss Account each year of an amount which, if invested at compound interest, will produce the required sum at the end of a given period. The investments so made are usually held in the names of the trustees for the debenture holders. When redemption takes place, the investments will be sold and the debenture holders paid off. The amounts standing to the credit of the redemption or sinking fund will then represent accumulated profit, but in place of being invested in specific assets, will be represented by the general assets of the business which had previously been subject to the charge of the debentures. The amount of such fund should therefore be transferred to reserve. It cannot, as a rule, be used for the payment of dividends, since it may not be represented by available cash ; but there would be no legal objection to its being utilised in this way if the liquid funds were available, since it has been built up out of revenue.

Where debentures have been redeemed in the open market at a discount, but the full nominal amount has

been provided for by the operation of a sinking fund, profit on the redemption can be taken to the Profit and Loss Account, as it represents an amount previously provided in excess of that actually required for redemption. It is, however, preferable to place the amount to reserve.

Where no sinking fund has been provided, any profit on redemption should be taken to reserve and not credited to the Profit and Loss Account.

In vouching the redemption of debentures, the auditor should examine the cancelled debenture bond or registered certificate, and inspect the directors' minute authorising the redemption.

In place of investing the redemption fund in securities, it is a common practice to take out an endowment policy with some reputable assurance company, under which annual premiums are paid, the company undertaking to provide the capital sum required, at the end of a given period. Such policies will be assigned to the trustees for the debenture holders, but the premiums will be paid by the company; the annual amount thereof being debited to the Profit and Loss Account and credited to the Redemption Account, while the premiums paid will be debited to the Policy Account. The only distinction between this method and that of making specific investments is that accruing interest will not be received in cash or require to be invested. Unless some account is taken of accruing interest, the book value of the policy will ultimately be less than the surrender value, which, in such cases, is often the whole of the premiums paid except the first premium, together with 2½ per cent. per annum compound interest.

It might be thought undesirable to include the first premium as an asset in the Balance Sheet, having regard to the fact that account of it is not taken in the surrender value ; but policies of this nature are not as a rule taken out for the purpose of surrender, and the value of the asset should therefore be looked at from the point of view of the company as a going concern.

In order that the asset representing the Redemption Account should bear some proper relation to the facts of the case, it is convenient to increase the Policy Account by debiting it with compound interest, such interest being credited to the Redemption Account; but it is *not necessary* that this should be done, as the operation does not affect revenue. In any event, there will no doubt be some difference, when the policy matures, between the amount received and the balance on the Policy Account, and any profit on the policy represented by accumulated interest not already dealt with should be credited to the Redemption Account, which will thus be brought up to the realised value of the policy, and be available for transfer to reserve in the manner previously described.

Where debentures are redeemable by annual drawings on the principle of a sinking fund, although it is necessary to debit Profit and Loss Account and credit the Redemption Account with the amount required for the annual drawing, it will not be necessary to invest such an amount, as the money represented thereby is immediately paid out in discharge of the drawn debentures. The amount standing to the credit of the Redemption Account will, as soon as the debentures have been drawn and paid off, be transferred to reserve.

Debentures may also be irredeemable or perpetual, and specific provision is made for the legality of such debentures by Section 89 of the Companies Act, 1948.

Power is granted to re-issue redeemed debentures in certain cases by Section 90 of the Companies Act, 1948. Under this section, where either before or after the commencement of the Act, a company has redeemed any debentures previously issued, then unless any provision to the contrary is contained in the Articles, or in any contract entered into by the company, or the company has passed a resolution, or by some other act indicates its intention that the debentures shall be cancelled, the company shall have, and shall be deemed always to have had power to re-issue the debentures, either by re-issuing the same debentures, or by issuing other debentures in their place.

Where a company has power to re-issue debentures which have been redeemed, particulars with respect to the debentures which can be so re-issued must be included in every Balance Sheet of the company issued subsequent to the redemption and up to the date of re-issue.

§ 6.—Preliminary and Formation Expenses.

This is the term given to the expenses incidental to the creation and flotation of a company. The following items are usually included under this heading :—

(1) Stamp duties and fees on the nominal capital, and stamps on the contracts transferring the assets.

(2) The law costs of preparing the prospectus, memorandum and articles of association, and contracts, and of the registration of the company.

(3) Accountants' and valuers' fees for reports, certificates, etc.

(4) Cost of printing memorandum and articles of association, and printing, advertising, and issue of prospectuses.

(5) Cost of preparing, printing and stamping letters of allotment, and providing share certificates.

(6) Cost of preparing, printing and stamping debentures and debenture trust deed (if any).

(7) Cost of company's seal, statutory books, and original books of account.

These preliminary and formation expenses are sometimes borne entirely by the company, and sometimes by the promoters or the vendors, or apportioned between these parties, the expenses up to allotment being payable by the promoters or by the vendors, and the expenses afterwards by the company. Care must be taken to see that the company is only charged with expenses properly payable by it, and the auditor must examine the contracts relating to these expenses, and vouch the payments made. This expenditure is of a capital nature, but as it is not represented by available assets, it is advisable that it should be written off as soon as possible out of revenue, and this is usually performed within three to five years, the balance not written off being carried forward in the Balance Sheet as an asset.

Where a premium is received on shares issued, it is common to find the preliminary expenses charged against such premium, and power to do so is given by Section 56, Companies Act, 1948.

Expenditure in connection with preliminary expenses, so far as it has not been written off to date,

must be shown as a separate item in the Balance Sheet of the company, and any expenses incurred in connection with the issue of share capital or debentures must also be shown separately.

Underwriting commission and commission on placing shares must not be included in the general heading "Preliminary Expenses," but must be shown separately on the Balance Sheet, until written off.

§ 7.—Commission on Issue of Shares.

Underwriting commission is the amount payable to persons who undertake to subscribe for a certain number of shares, in the event of the public not taking up the whole of the shares offered. An underwriting contract is therefore in the nature of a speculation. If the public subscribe to the total extent of the shares offered, the underwriters receive their commission, and do not have to take up any shares. If the public do not subscribe for the issue in full, the underwriters have to take up the shares not subscribed for, in proportion to their contracts. It is usual for the underwriters to make formal application for the shares they underwrite, on the understanding that allotments to them will be made only to the extent to which the public do not apply.

Commission on placing shares is an amount payable to parties who introduce to the company persons who are willing to become members, and to take up shares accordingly. This commission, therefore, differs from underwriting commission, in-so-far as it is not a speculative transaction, and is only paid in the event of capital being introduced.

Section 53 of the Companies Act, 1948, empowers companies to pay commission of this nature under certain conditions. The amount or rate per cent. of

the commission (which must not exceed 10 per cent. of the price at which the shares are issued or the amount or rate authorised by the Articles, whichever is the lower) must be authorised by the Articles of Association and disclosed in the prospectus or in the statement required to be filed with the Registrar in lieu thereof, and in any invitation to subscribe for shares not being a prospectus. The number of shares which persons have agreed for a commission to subscribe absolutely must also be disclosed in the same manner.

This commission is usually payable in cash, but sometimes it is effected by the issue of fully paid shares, or partly in cash and partly in shares.

In some companies, in place of paying commission, an option is given to the underwriters to subscribe within a specified period for a certain portion of the company's unissued shares at par or at a fixed premium, and where such shares are likely to go to a high premium, this option may be of considerable value. It was held by the House of Lords (*Hilder* v. *Dexter*, 1902, A.C. 474) that such an arrangement is not an application of shares in payment of commission within the meaning of Section 53 as quoted above. Where such an option has been given, the auditor must see that a note thereof appears on the accounts or in a statement or report annexed thereto giving particulars of the period during which the option is exercisable, and the price to be paid for the shares subscribed under it (Eighth Schedule, Part I, (11) (2)).

In order to vouch the payment of underwriting commission, the auditor should examine the Articles of Association, where power is given to make payments of this nature, and should ascertain that the provisions

of Section 53 have been duly complied with. The underwriting contract should be seen and also the application letters signed by the underwriters. The amount or rate per cent. paid must not exceed that authorised, and where payment has been made in shares, it should be seen that the proper contracts have been filed.

There have been a number of cases where the underwriters of large blocks of shares have been companies with very small capitals, which have been unable to take up and pay for the shares underwritten when the issue was not successful. The auditor, therefore, on finding that the underwriter's calls or payments on allotment are in arrear, should report the matter to the members, and give full particulars. It has occasionally occurred in these cases that the directors of the company are also directors of the underwriting company, and have merely forfeited the shares on the failure to pay the call. The auditor must see that the forfeiture is a valid one, as any small departure from the procedure laid down in the Articles (or in Table "A," as the case may be) will invalidate it.

The vouching of commission on placing shares is somewhat more difficult, as it is not easy for the auditor to satisfy himself that commission paid to any persons is in respect of applications actually introduced by such persons. No commission should be paid unless the application form on which the shares have been allotted was initialled by the party claiming the commission before being sent in to the company, and the auditor should examine the application forms in respect of which such commission is payable, to

ascertain whether this has been done. All commission of this nature should be referred to in the minutes, and a resolution passed by the directors for the payment thereof.

Brokerage on placing shares is an amount payable to brokers and other agents whose clients have subscribed for shares in the company, on application forms stamped with the agent's stamp.

Such a brokerage, not exceeding 2½ per cent., has been held to be *intra vires* the company (*Metropolitan Coal Consumers Association* v. *Scrimgeour*, 1895, 2 Q.B. 604), and the payment thereof is not subject to the restrictions imposed by Section 53. In order to vouch items of this nature, the auditor should examine the application letters, ascertaining that these are stamped by the agents concerned.

The total of any sums paid or allowed by way of commission in respect of any shares, or so much thereof as has not been written off, must be stated separately in every Balance Sheet. The Annual Summary must disclose the total amount of the sums (if any) paid by way of commission in respect of any shares since the date of the last return.

There is nothing in the Act to prevent the payment of such commissions out of revenue, should the Articles give power to do so; and such transactions are not subject to the restrictions imposed by Section 53.

§ 8.—The Statutory Audit.

This is a term commonly applied to the audit required to be performed by the auditor, if appointed prior to the *statutory meeting* of the company. Under

Section 130 of the Companies Act, 1948, every *public* company must hold a general meeting not less than one month, nor more than three months, after the date on which the company is entitled to commence business, and such meeting is called the statutory meeting.

At least fourteen days before the date on which such meeting is to be held, the directors must forward a report, called the *statutory report*, to every member of the company. This report must be certified by not less than two of the directors, or where there are less than two directors by the sole director and manager, and must state—

(*a*) The total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted ;

(*b*) The total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid ;

(*c*) An abstract of the receipts of the company, and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company.

(*d*) The names, addresses and descriptions of the directors, auditors (if any), managers (if any), and secretary of the company.

(*e*) The particulars of any contract, the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

So much of the report as relates to the shares allotted by the company and the cash received in respect of such shares, and the receipts and payments of the company on capital account, must be certified by the auditors (if any) of the company.

The work to be performed by the auditor in connection with the shares allotted and cash received in respect thereof, will follow the lines laid down for the audit of the issue of share capital in § 2 (*b*) and (*c*) of this chapter.

The manner in which the section is worded makes it clear that a summarised Cash Account must be supplied, although apparently there is no necessity for revenue receipts and payments to be shown in any detail, nor is the auditor concerned therewith at this stage, since his certificate is only designed to cover the receipts and payments of the company on capital account.

The auditor must examine the contracts with the vendors, and vouch all payments; the work necessary in connection with the vouching of payments for the preliminary and formation expenses and commission on the issue of shares has already been discussed.

A *private* company is *not* required to hold a statutory meeting or prepare a statutory report.

The form of the auditors' certificate in connection with this report is as follows :—

"WE, the undersigned, being the auditors of the company, hereby certify that so much of this report as relates to the shares allotted, the cash received in respect of such shares, and the receipts and payments of the company on capital account is correct."

The following is a form of the statutory report of the directors :—

No. of Company }

THE COMPANIES ACT, 1948.

REPORT pursuant to s. 130 of the Companies Act, 1948.

of

Limited

NOTE.—This form has been provided for the purpose of indicating the nature of the information that is required; but the report to be filed must be a copy of that sent to the shareholders.

(*a*) The total number of shares allotted is

of which are allotted (1)

(1) Here state "as fully paid "up or" as paid "up otherwise "than in cash to "the extent of " per share"

in consideration of

and upon each of the remaining shares the sum of has been paid in cash.

(*b*) The total amount of cash received by the company in respect of the shares issued wholly for cash is £

and on the shares issued partly for cash is £

(*c*) The receipts and payments of the company on capital account to the date of this report are as follows :—

Particulars of Receipts.		Particulars of Payments.		

The following is an account (or estimate) of the preliminary expenses of the company.

(*d*) Names, addresses and descriptions of the directors, auditors (if any), managers (if any), and secretary of the company.

DIRECTORS.

Surname.	Christian Name.	Address.	Description.

AUDITORS

MANAGERS.

SECRETARY.

(*e*) Particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

We hereby certify this report.

} Two Directors.

We hereby certify that so much of this report as relates to the shares allotted by the company and to the cash received in respect of such shares and to the receipts and payments of the company on capital account is correct.

} Auditors.

Dated the ______ day of ______ 19

§ 9.—Adjustment of Accounts with Vendors.

(a) Purchase of Business.

Where a company acquires a business, the auditor should vouch the journal entries recording the assets acquired and liabilities taken over (if any), with the contracts between the vendors and the company. Where a prospectus has been issued, the amount payable for goodwill must be specified therein, and will be equivalent to the difference between the value of the tangible assets acquired and the amount of the consideration payable to the vendors, plus the liabilities taken over (if any).

Where the purchase consideration is less than the value of the tangible assets acquired, there will be no goodwill, but on the other hand a surplus will be shown representing a book profit. The cost of such assets to the company is only the amount paid therefor, and consequently any apparent surplus should preferably be utilised in adjusting the values of the assets acquired. Where, however, such treatment is not desired, the amount should be placed to the credit of a Capital Reserve Account, which will not be available for revenue purposes.

Where a reconstruction has taken place, and a new company has been formed to take over from the liquidator of the old company all the assets of that company, and possibly also to undertake certain of its liabilities, the old company receiving the purchase consideration either wholly or partially in shares of the new company, the auditor of the reconstructed company should examine the contract under which the assets are acquired, and ascertain that all such assets are duly brought into account. In some cases the liabilities of the old company may

be wholly or partially satisfied by the issue of shares or debentures, and where this is so, the auditor should vouch the issue of such shares or debentures, and ascertain that it is in accordance with the contract.

(b) Apportionment of Profit or Loss prior to Incorporation.

Frequently a company takes over a business as and from a date prior to the incorporation of the company itself. In such an event any profits earned prior to the date of incorporation, to which the company may be entitled, cannot be regarded as profits available for dividend, but are of a capital nature, since the company cannot earn profits before it comes into existence. When the vendors are not entitled to take such profits, they are usually entitled to interest on the purchase consideration from the date when the business was taken over to the date when the purchase consideration is discharged. If that is so, the interest payable to the vendors for the period from the date of taking over the business till the date of incorporation can be charged against the profits earned during that period, any interest payable in respect of any period after the date of incorporation being charged against the Profit and Loss Account. The remaining balance of profit earned prior to incorporation (if any) should either be written off the goodwill, or, if there is no goodwill, some other fixed asset, or carried forward as a capital reserve not available for revenue purposes.

If stock is not taken at the date of incorporation, and the exact profits thereto cannot consequently be ascertained, it is necessary to arrive at the approximate proportion of profits applicable to the period prior to incorporation. This may be done by apportioning the whole profits earned according to the time

covered by the respective periods, or in proportion to the turnover of those periods. A more accurate division of profits will, however, be obtained by apportioning the *gross* profit, and the expenses which vary with turnover, between the two periods on the basis of their respective turnovers, and all other expenses on the basis of time.

The date of the division, in these cases, should be the date of incorporation, and not the date of the certificate entitling the company to commence business ; since once that certificate has been issued the company's power of legally carrying on business dates back to the date of incorporation.

The auditor must take care to see that an equitable division of profit has been made between the two periods, and that the period subsequent to incorporation (the profits of which are available for dividends) has not been favoured at the expense of the prior period.

In the event of a loss in the first period it is not usual to make any apportionment in respect of the period prior to incorporation, but to carry forward the debit balance against future profits. However, there is nothing to prevent the proportion of the loss relating to the period prior to incorporation being added to the Goodwill Account as it represents, in fact, an increase in the price paid for that asset.

(c) Receipts and Payments on behalf of Vendors.

In some instances the company does not acquire the book debts from the vendors, but, for the purposes of convenience, undertakes to collect them on their behalf. In such cases, the company does not, as a rule, take over the liabilities, but for similar reasons arranges to pay these liabilities out of the proceeds of the book

debts. Where this is so, the assets and liabilities concerned should be brought into the books of the company for the purpose of recording what ought to be collected and paid away on behalf of the vendors, the book debts being credited to the vendors and the liabilities debited. The auditor should see that the cash received from the debtors, or the payments made to the creditors, are duly apportioned as between the company and the vendors. Any discounts or bad debts relating to the vendors' book debts must be borne by the vendors.

Sometimes the company takes over the book debts, their value being guaranteed by the vendors. Any bad debts incurred relating to such debts will therefore be charged to the vendors. It is an open point whether cash discount allowed on payment of such debts within the usual term of credit can be so charged; but this will depend on the precise wording of the contract with the vendors. The auditor should take care to ascertain that all losses properly chargeable against the vendors are debited to them.

The vendors' contract should be consulted to ascertain whether there are any provisions other than those above referred to affecting the adjustment of the accounts between the vendors and the company. It is sometimes arranged that the vendors shall account for all moneys withdrawn from the business between the date from which the company acquires it and the date when the company takes it over, and in the same manner any sums paid into the business during that period, by the vendors, may be repayable to them.

§ 10.—The Annual Audit.

As indicated in § 4 of Chapter VI, it is the duty of the auditor to make a report on the accounts

examined by him, and on every Balance Sheet, every Profit and Loss Account and all group accounts laid before the company in general meeting.

(a) The Books of Account.

Under Section 147 of the Act every company shall cause to be kept proper books of account with respect to—

(*a*) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place;

(*b*) all sales and purchases of goods by the company;

(*c*) the assets and liabilities of the company.

The section further provides that such books must be kept as will give a true and fair view of the state of the company's affairs and explain its transactions.

The necessary books must be kept at the registered office of the company, or at such other place as the directors may think fit, and shall at all times be open to inspection by the directors.

If books of account are kept at a place outside Great Britain, returns and accounts which disclose with reasonable accuracy the financial position of that business must be sent to and kept in Great Britain, at intervals not exceeding six months. The returns and accounts must be in such a form as will enable the company to prepare its Balance Sheet and Profit and Loss Account and any documents required by the Act to be annexed thereto.

Failure to take all reasonable steps to comply with the requirements of Section 147 will, if the Court considers the offence to have been committed wilfully, involve a director in a liability to imprisonment for

a term not exceeding six months. The section also provides an alternative penalty of a fine of £200. It will be a defence to any action brought against him for the director to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the requirements of the Act were complied with.

Under Section 331 it is provided that if proper books of account are not kept throughout the period of two years immediately preceding the commencement of the winding-up of a company or the period between the incorporation of the company and the commencement of the winding-up, whichever is the shorter, every officer of the company who was in default, is liable to imprisonment for a term not exceeding one year, or on summary conviction, six months, unless he can show that he acted honestly and that in the circumstances in which the business was carried on the default was excusable. For the purposes of this section, such books and accounts must be kept as are necessary to exhibit and explain the transactions and financial position of the trade or business of the company, so as to contain entries from day to day in sufficient detail of all cash received and paid, and where dealings in goods are involved, statements of the annual stock-takings, and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

These provisions are analogous to those contained in Section 147, but it will be observed that in the event of liquidation, failure to keep stocktaking statements will render the officers liable to penalties.

It will be remembered that under the Ninth Schedule, Companies Act, 1948, the specific duty is imposed upon auditors to report to the members "whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them."

(b) The Profit and Loss Account.

The directors of every company shall at some date, not later than eighteen months after the incorporation of the company, and subsequently once at least in every calendar year, lay before the company in general meeting a Profit and Loss Account, or, in the case of a non-trading company, an Income and Expenditure Account for the period, in the case of the first account, since the incorporation of the company, and in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months, or in the case of a company carrying on business or having interests abroad, by more than twelve months. These periods may be extended in special circumstances by the Board of Trade (Section 148).

The Eighth Schedule, Companies Act, 1948, sets forth the items and information which must be shown in the Profit and Loss Account. These provisions are set out hereunder :—

12.—(1) There shall be shown—

(*a*) the amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets ;

(*b*) the amount of the interest on the company's debentures and other fixed loans ;

(*c*) the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including,

where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing where practicable between income tax and other taxation ;

(*d*) the amounts respectively provided for redemption of share capital and for redemption of loans ;

(*e*) the amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves ;

(*f*) subject to sub-paragraph (2) of this paragraph, the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof ;

(*g*) the amount of income from investments, distinguishing between trade investments and other investments ;

(*h*) the aggregate amount of the dividends paid and proposed.

(2) The Board of Trade may direct that a company shall not be obliged to show an amount set aside to provisions in accordance with sub-paragraph (1) (*f*) of this paragraph, if the Board is satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account the amount set aside as aforesaid shall be so framed or marked as to indicate that fact.

13. If the remuneration of the auditors is not fixed by the company in general meeting, the amount thereof shall be shown under a separate heading, and for the purposes of this paragraph, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression " remuneration."

14.—(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, if not otherwise shown.

(2) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.

(3) The basis on which the charge for United Kingdom income tax is computed.

(4) Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.

(5) Except in the case of the first profit and loss account laid before the company after the commencement of this Act the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account.

(6) Any material respects in which any items shown in the profit and loss account are affected—

(a) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

(b) by any change in the basis of accounting.

The above provisions do not apply to banking or discount companies, with the exception of paragraphs 12 (1) (h), 13 and 14 (1) (4) and (5). In the case of such companies, however, if in the Balance Sheet capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision must be so framed or marked as to indicate that fact, and the profit and loss account must indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.

Similar exemption is given to assurance companies which deposit accounts with the Board of Trade under the provisions of the Assurance Companies Acts, 1909 to 1946. The Board of Trade may grant exemption from the requirements of the Schedule to any class of companies if it considers this to be desirable in the national interest.

The special provisions of the Act dealing with the consolidated accounts of holding companies and subsidiaries are dealt with in Chapter IX.

In addition to the aforementioned requirements, Section 196, Companies Act, 1948, provides for the disclosure in the accounts of directors' salaries, pensions, etc. This section is very comprehensive and is given in detail hereunder:—

(1) In any accounts of a company laid before it in general meeting, or in a statement annexed thereto, there shall, subject to

and in accordance with the provisions of this section, be shown so far as the information is contained in the company's books and papers or the company has the right to obtain it from the persons concerned—

(*a*) the aggregate amount of the directors' emoluments;

(*b*) the aggregate amount of directors' or past directors' pensions; and

(*c*) the aggregate amount of any compensation to directors or past directors in respect of loss of office.

(2) The amount to be shown under paragraph (*a*) of subsection (1) of this section—

(*a*) shall include any emoluments paid to or receivable by any person in respect of his services as director of the company or in respect of his services, while director of the company, as director of any subsidiary thereof or otherwise in connection with the management of the affairs of the company or any subsidiary thereof; and

(*b*) shall distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments;

and for the purposes of this section the expression "emoluments," in relation to a director, includes fees and percentages, any sums paid by way of expenses allowance in-so-far as those sums are charged to United Kingdom income tax, any contribution paid in respect of him under any pension scheme and the estimated money value of any other benefits received by him otherwise than in cash.

(3) The amount to be shown under paragraph (*b*) of the said subsection (1)—

(*a*) shall not include any pension paid or receivable under a pension scheme if the scheme is such that the contributions thereunder are substantially adequate for the maintenance of the scheme, but save as aforesaid shall include any pension paid or receivable in respect of any such services of a director or past director of the company as are mentioned in the last foregoing subsection, whether to or by him or, on his nomination or by virtue of dependence on or other connection with him, to or by any other person; and

(*b*) shall distinguish between pensions in respect of services as director, whether of the company or its subsidiary, and other pensions;

and for the purposes of this section the expression "pension" includes any superannuation allowance, superannuation gratuity or similar payment, and the expression "pension scheme" means a scheme for the provision of pensions in respect of services as director or otherwise which is maintained in whole or in part by

means of contributions, and the expression "contribution" in relation to a pension scheme means any payment (including an insurance premium) paid for the purposes of the scheme by or in respect of persons rendering services in respect of which pensions will or may become payable under the scheme, except that it does not include any payment in respect of two or more persons if the amount paid in respect of each of them is not ascertainable.

(4) The amount to be shown under paragraph (*c*) of the said subsection (1)—

(*a*) shall include any sums paid to or receivable by a director or past director by way of compensation for the loss of office as director of the company or for the loss, while director of the company or on or in connection with his ceasing to be a director of the company, of any other office in connection with the management of the company's affairs or of any office as director or otherwise in connection with the management of the affairs of any subsidiary thereof; and

(*b*) shall distinguish between compensation in respect of the office of director, whether of the company or its subsidiary and compensation in respect of other offices;

and for the purposes of this section references to compensation for loss of office shall include sums paid as consideration for or in connection with a person's retirement from office.

(5) The amounts to be shown under each paragraph of the said subsection (1)—

(*a*) shall include all relevant sums paid by or receivable from—

(i) the company; and

(ii) the company's subsidiaries; and

(iii) any other person;

except sums to be accounted for to the company or any of its subsidiaries or, by virtue of section **one hundred and ninety-three** of this Act, to past or present members of the company or any of its subsidiaries or any class of those members; and

(*b*) shall distinguish, in the case of the amount to be shown under paragraph (*c*) of the said subsection (1), between the sums respectively paid by or receivable from the company, the company's subsidiaries and persons other than the company and its subsidiaries.

(6) The amounts to be shown under this section for any financial year shall be the sums receivable in respect of that year, whenever paid, or, in the case of sums not receivable in respect of a period, the sums paid during that year, so, however, that where—

(a) any sums are not shown in the accounts for the relevant financial year on the ground that the person receiving them is liable to account therefor as mentioned in paragraph (a) of the last foregoing subsection, but the liability is thereafter wholly or partly released or is not enforced within a period of two years; or

(b) any sums paid by way of expenses allowance are charged to United Kingdom income tax after the end of the relevant financial year;

those sums shall, to the extent to which the liability is released or not enforced or they are charged as aforesaid, as the case may be, be shown in the first accounts in which it is practicable to show them or in a statement annexed thereto, and shall be distinguished from the amounts to be shown therein apart from this provision.

(7) Where it is necessary so to do for the purpose of making any distinction required by this section in any amount to be shown thereunder, the directors may apportion any payments between the matters in respect of which they have been paid or are receivable in such manner as they think appropriate.

(8) If in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.

(9) In this section any reference to a company's subsidiary—

(a) in relation to a person who is or was, while a director of the company, a director also, by virtue of the company's nomination, direct or indirect, of any other body corporate, shall, subject to the following paragraph, include that body corporate, whether or not it is or was in fact the company's subsidiary; and

(b) shall for the purposes of subsections (2) and (3) be taken as referring to a subsidiary at the time the services were rendered, and for the purposes of subsection (4) be taken as referring to a subsidiary immediately before the loss of office as director of the company.

It will be observed that a distinction must be drawn between emoluments paid to a director as director and those paid for management services, and that the directors may make any necessary apportionment of sums paid to them in order to give the requisite information. In view of the doubt which may some-

times arise as to how the distinction between "director" and "management" services is to be interpreted, the Institute of Chartered Accountants obtained the following opinion from counsel :—

"In our opinion, Section 196, Companies Act, 1948, is intended to draw a distinction between service as a director and service as manager or executive. The conception seems to be that directors control the policy of the company, whereas managers carry out the decisions of the directors and take the action necessary to give effect to those decisions. The distinction is not easy to work out logically, since the directors are inherently managers. In sub-section 196 (2) (*b*), both directorial and managerial functions are referred to : the directorial functions by the words 'in respect of his services as a director' and the managerial functions by the words 'or otherwise in connection with the management of the affairs of the company.'

"In our opinion, emoluments in respect of services 'as director' are those fees which are paid to directors in their capacity as such and not in any managerial or executive capacity. Normally these would be fees fixed either by the articles or by the company in general meeting but they would, we think, include remuneration paid to directors for special services, *e.g.*, for going or residing abroad or for serving on committees.

"Emoluments paid in connection with the management of the affairs of the company in our opinion mean remuneration paid to a director for services in a managerial or executive capacity, *e.g.*, as managing director, manager, secretary or as a departmental head. Such remuneration would normally be paid under a service contract.

"The power given to the directors by Section 196 (7) to apportion is expressed as being permissive ; but if it is necessary to exercise the power in order that the accounts may give the information required by the section or a true and fair view of the state of the company's affairs, then the directors must exercise the power. Thus if a managing director were paid say, £5,000 a year inclusive of directors' fees, it would be necessary to apportion the sum between the directorial and managerial functions. If he were paid £5,000 plus directors' fees no question of apportionment would arise. If he were paid £5,000 a year as managing director and had no right under the articles to directors' fees, again no apportionment would be necessary."

Section 196 (2) provides that the expression "emoluments" in relation to a director includes "the estimated money value of any other benefits received by him otherwise than in cash." The question as to what constitutes a benefit and the assessment of the monetary value thereof of such benefit presents considerable difficulty for the auditor. Examples of

benefits which a director may derive from the company are: the free use of living accommodation, the free use of motor cars, goods and services supplied by the company without charge or at less than normal prices, regular luncheons, etc. Very similar provisions were enacted by the Finance Act, 1948, under which benefits or facilities in kind are regarded for taxation purposes as perquisites of the office of director. The position for taxation purposes provides a useful guide to directors and auditors as to the benefits which must be disclosed in the accounts under the Companies Act, 1948.

The opinion of counsel obtained on this matter by the Institute of Chartered Accountants is reproduced hereunder:—

"In our opinion it is the duty of the auditor to make enquiry from the company and from the directors in order that he may verify the benefits obtained by the directors otherwise than in cash. This duty is imposed by the Ninth Schedule which requires an auditor to report whether in his opinion and to the best of his information and according to the explanations given to him the accounts give the information required by the Act. Section 196 (2) requires the aggregate of the directors' emoluments to be shown in the accounts or in a statement annexed thereto, and subsection (8) imposes a direct obligation on the auditor to supplement the information in his report, if it is deficient. The auditor must assess the value of the benefits to the best of his ability and satisfy himself that the value of benefits has been shown at a fair figure.

"We do not think that an auditor could place himself in a position to perform his duties unless he obtained an assurance from the directors that no benefits had been received otherwise than in cash or alternatively a statement of such benefits.

"In our opinion the fact that an independent quorum of the board passes a resolution to the effect that some particular expense is incurred for the benefit of the company and not for the benefit of a director is in no way conclusive of the facts. The two things are not necessarily in opposition. An expense, although incurred for the benefit of the company, may none the less benefit a director, *e.g.*, the managing director of an hotel lives with his family in a flat in the hotel free of charge. This would no doubt be a benefit to the company but it is also a benefit to the director and its value would be an emolument."

It is the duty of a director to give notice to the company of any benefits he has received therefrom.

In this connection the Council of the Institute of Chartered Accountants issued the following recommendation :—

" Where the notice to be given by each director under Section 198 (1) is not given in writing in the form of a statement of pensions, compensation and emoluments, including all benefits received otherwise than in cash, approved by the Board and recorded in the minutes, the auditor should require such a statement in writing approved by a resolution of the Board."

As has already been indicated, prior to the Companies Act, 1948, no specific responsibility was imposed upon an auditor for the accuracy of the Profit and Loss Account, and the Companies Act, 1929, virtually made no provision for the items which should be shown separately therein. As a result, many companies presented to their shareholders Profit and Loss Accounts in such an abridged form that they contained little useful information. It was also possible for the amount shown as the profit for the year to give a very misleading impression of the company's actual trading results owing to the inclusion of non-recurring items, withdrawals from secret reserves, etc. Although this position was improved considerably as a result of the *Royal Mail* case (*see* Chapter X), which made clear to auditors the great risks they incurred by not reporting that material sums had been withdrawn from secret reserves to augment the published profit figures, there was no statutory authority to support the auditor's insistence upon disclosure of such items. The auditor's position has been strengthened considerably by clause 14 (6) Eighth Schedule to the Companies Act, 1948, which imposes upon the directors an obligation to disclose in the accounts or by way of a note any material respects in which any items shown in the Profit and Loss Account are affected by—

(*a*) transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature ; or

(*b*) any change in the basis of accounting.

In this regard the following recommendation has been made by the Council of the Institute of Chartered Accountants:

"The disclosure of the results of the period implies substantial uniformity in the accounting principles applied as between successive accounting periods any change of a material nature, such as a variation in the basis of stock valuation or in the method of providing for depreciation or taxation, should be disclosed if its effect distorts the results. The account should disclose any material respects in which it includes extraneous or non-recurrent items or those of an exceptional nature, and should also refer to the omission of any item relative to, or the inclusion of any item not relative to, the results of the period."

It will also be remembered that it is the auditor's duty to state in his report whether in his opinion the profit and loss account gives a true and fair view of the company's profit or loss *for its financial year.*

(c) The Balance Sheet.

(1) *Requirements.*

Under Section 148 (2) a Balance Sheet must be made out in every calendar year as at the date to which the Profit and Loss Account or Income and Expenditure Account is made up, and default in so doing will involve penalties similar to those enforceable in the event of failure to keep proper books of account.

The Balance Sheet, which must be signed on behalf of the Board by two directors, or if there is only one director by that director, must give a true and fair view of the state of affairs of the company at the end of its financial year and comply with the requirements of the Eighth Schedule to the Act. These requirements are given in detail hereunder :—

1. The authorised share capital, issued share capital, liabilities and assets shall be summarised, with such particulars as are necessary to disclose the general nature of the assets and liabilities, and there shall be specified—

(*a*) any part of the issued capital that consists of redeemable preference shares, and the earliest date on which the company has power to redeem those shares;

(*b*) so far as the information is not given in the profit and loss account, any share capital on which interest has been paid out of the capital during the financial year, and the rate at which interest has been so paid;

(*c*) the amount of the share premium account;

(*d*) particulars of any redeemed debentures which the company has power to re-issue.

2. There shall be stated under separate headings, so far as they are not written off—

(*a*) the preliminary expenses;

(*b*) any expenses incurred in connection with any issue of share capital or debentures;

(*c*) any sums paid by way of commission in respect of any shares or debentures;

(*d*) any sums allowed by way of discount in respect of any debentures; and

(*e*) the amount of the discount allowed on any issue of shares at a discount.

3.—(1) The reserves, provisions, liabilities and fixed and current assets shall be classified under headings appropriate to the company's business:

Provided that—

(*a*) where the amount of any class is not material, it may be included under the same heading as some other class; and

(*b*) where any assets of one class are not separable from assets of another class, those assets may be included under the same heading.

(2) Fixed assets shall also be distinguished from current assets.

(3) The method or methods used to arrive at the amount of the fixed assets under each heading shall be stated.

4.—(1) The method of arriving at the amount of any fixed assets shall, subject to the next following sub-paragraph, be to take the difference between—

(*a*) its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and

(*b*) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value ;

and for the purposes of this paragraph the net amount at which any assets stand in the company's books at the commencement of this Act (after deduction of the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before the commencement of this Act cannot be obtained without reasonable expense or delay, be treated as if it were the amount of a valuation of those assets made at the commencement of this Act and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets.

(2) The foregoing sub-paragraph shall not apply—

(*a*) to assets for which the figures relating to the period beginning with the commencement of this Act cannot be obtained without unreasonable expense or delay ; or

(*b*) to assets the replacement of which is provided for wholly or partly—

(i) by making provision for renewals and charging the cost of replacement against the provision so made ; or

(ii) by charging the cost of replacement direct to revenue ; or

(*c*) to any investment of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of note ; or

(*d*) to goodwill, patents or trade marks.

(3) For the assets under each heading whose amount is arrived at in accordance with sub-paragraph (1) of this paragraph, there shall be shown—

(*a*) the aggregate of the amounts referred to in paragraph (*a*) of that sub-paragraph ; and

(*b*) the aggregate of the amounts referred to in paragraph (*b*) thereof.

(4) As respects the assets under each heading whose amount is not arrived at in accordance with the said sub-paragraph (1) because their replacement is provided for as mentioned in sub-paragraph (2) (*b*) of this paragraph, there shall be stated—

(*a*) the means by which their replacement is provided for ; and

(*b*) the aggregate amount of the provision (if any) made for renewals and not used.

5. The aggregate amounts respectively of capital reserves, revenue reserves and provisions (other than provisions for depreciation, renewals or diminution in value of assets) shall be stated under separate headings:

Provided that—

(*a*) this paragraph shall not require a separate statement of any of the said three amounts which is not material; and

(*b*) the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact.

6.—(1) There shall also be shown (unless it is shown in the profit and loss account or a statement or report annexed thereto, or the amount involved is not material)—

(*a*) where the amount of the capital reserves, of the revenue reserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived; and

(*b*) where—

(i) the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or

(ii) the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof;

the application of the amounts derived from the difference.

(2) Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, this paragraph shall apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof.

7.—(1) There shall be shown under separate headings—

(*a*) the aggregate amounts respectively of the company's trade investments, quoted investments other than trade investments and unquoted investments other than trade investments;

(*b*) if the amount of the goodwill and of any patents and trademarks or part of that amount is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the said amount so shown or ascertained so far as not written off or, as the case may be, the said amount so far as it is so shown or ascertainable and as so shown or ascertained, as the case may be;

(*c*) the aggregate amount of any outstanding loans made under the authority of provisos (*b*) and (*c*) of subsection (1) of section fifty-four of this Act;

(*d*) the aggregate amount of bank loans and overdrafts;

(*e*) the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend.

(2) Nothing in head (*b*) of the foregoing sub-paragraph shall be taken as requiring the amount of the goodwill, patents and trademarks to be stated otherwise than as a single item.

(3) The heading showing the amount of the quoted investments other than trade investments shall be sub-divided, where necessary, to distinguish the investments as respects which there has, and those as respects which there has not, been granted a quotation or permission to deal on a recognised stock exchange.

8. Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured.

9. Where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.

10.—(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, or in a statement or report annexed, if not otherwise shown.

(2) The number, description and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say—

(*a*) the period during which it is exercisable;

(*b*) the price to be paid for shares subscribed for under it.

(3) The amount of any arrears of fixed cumulative dividends on the company's shares and the period for which the dividends or, if there is more than one class, each class of them are in arrear, the

amount to be stated before deduction of income tax, except that, in the case of tax free dividends, the amount shall be shown free of tax and the fact that it is so shown shall also be stated.

(4) Particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured.

(5) The general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

(6) Where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for.

(7) If in the opinion of the directors any of the current assets have not a value, on realisation in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion.

(8) The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the stock exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their stock exchange value.

(9) The basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material.

(10) The basis on which the amount, if any, set aside for United Kingdom income tax is computed.

(11) Except in the case of the first balance sheet laid before the company after the commencement of this Act, the corresponding amounts at the end of the immediately preceding financial year for all items shown in the balance sheet.

When the company is a holding company, the following items must be shown separately in the Balance Sheet, or where appropriate by way of a note or in a statement annexed thereto. References are to Part II of the Eighth Schedule.

15.—(1) This paragraph shall apply where the company is a holding company, whether or not it is itself a subsidiary of another body corporate.

(2) The aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from the company's subsidiaries, distinguishing shares from indebtedness,

shall be set out in the balance sheet separately from all the other assets of the company, and the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be so set out separately from all its other liabilities and—

(*a*) the references in Part I of this Schedule to the company's investments shall not include investments in its subsidiaries required by this paragraph to be separately set out; and

(*b*) paragraph 5, sub-paragraph (1) (*a*) of paragraph 12, and sub-paragraph (2) of paragraph 14 of this Schedule shall not apply in relation to fixed assets consisting of interests in the company's subsidiaries.

(3) There shall be shown by way of note on the balance sheet or in a statement or report annexed thereto the number, description and amount of the shares in and debentures of the company held by its subsidiaries or their nominees, but excluding any of those shares or debentures in the case of which the subsidiary is concerned as personal representative or in the case of which it is concerned as trustee and neither the company nor any subsidiary thereof is beneficially interested under the trust, otherwise than by way of security only for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(4) Where group accounts are not submitted, there shall be annexed to the balance sheet a statement showing—

(*a*) the reason why subsidiaries are not dealt with in group accounts;

(*b*) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—

(i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) for their previous financial years since they respectively became the holding company's subsidiary;

(*c*) the net aggregate amount of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—

(i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) for their other financial years since they respectively became the holding company's subsidiary;

so far as those profits are dealt with, or provision is made for those losses, in the company's accounts;

(*d*) any qualifications contained in the report of the auditors of the subsidiaries on their accounts for their respective financial years ending as aforesaid, and any note or saving contained in those accounts to call attention to a matter which, apart from the note or saving, would properly have been referred to in such a qualification, in-so-far as the matter which is the subject of the qualification or note is not covered by the company's own accounts and is material from the point of view of its members;

or, in-so-far as the information required by this sub-paragraph is not obtainable, a statement that it is not obtainable:

Provided that the Board of Trade may, on the application or with the consent of the company's directors, direct that in relation to any subsidiary this sub-paragraph shall not apply or shall apply only to such extent as may be provided by the direction.

(5) Paragraphs (*b*) and (*c*) of the last foregoing sub-paragraph shall apply only to profits and losses of a subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where—

(*a*) the company is itself the subsidiary of another body corporate; and

(*b*) the shares were acquired from that body corporate or a subsidiary of it:

and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(6) Where group accounts are not submitted, there shall be annexed to the balance sheet a statement showing, in relation to the subsidiaries (if any) whose financial years did not end with that of the company—

(*a*) the reasons why the company's directors consider that the subsidiaries' financial years should not end with that of the company; and

(*b*) the dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates.

16.—(1) The balance sheet of a company which is a subsidiary of another body corporate, whether or not it is itself a holding company, shall show the aggregate amount of its indebtedness to all bodies corporate of which it is a subsidiary or a fellow subsidiary and the aggregate amount of the indebtedness of all such bodies corporate to it, distinguishing in each case between indebtedness in respect of debentures and otherwise.

(2) For the purposes of this paragraph a company shall be deemed to be a fellow subsidiary of another body corporate if both are subsidiaries of the same body corporate but neither is the other's.

The special provisions applicable to group accounts are dealt with in Chapter IX.

The distinction between fixed and current assets is best made by segregating the assets in the Balance Sheet under the main headings "fixed" and "current." If this method is not adopted, each individual asset must be described as being "fixed" or "current." Certain debit balances, which must appear on the assets side of a balance sheet, *e.g.*, preliminary expenses, debenture discount, an adverse balance on Profit and Loss Account, etc., could not correctly be described as fixed or current assets. The Council of the Institute of Chartered Accountants have been authorised by the Board of Trade to state "that no objection will be taken to an asset not being described as 'fixed' or 'current' if to do so would not be a true and fair description, provided the nature of the asset is stated clearly."

The terms "provision," "reserve," "revenue reserve," "capital reserve" and "liability" are defined by Part IV to the Eighth Schedule as follows :—

(*a*) the expression "provision" shall, subject to sub-paragraph (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy ;

(*b*) the expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of

providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability ;

(c) the expression "capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account and the expression "revenue reserve" shall mean any reserve other than a capital reserve ;

and in this paragraph the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

Where any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or any amount retained by way of providing for any known liability, is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess must be treated in the accounts as a reserve and not as a provision. This does not apply, however, to amounts *written off* fixed assets prior to 1st July, 1948, although, from a literal interpretation of the relevant provision, it would appear to apply to amounts *retained* prior to that date but not written off the book value of an asset, *e.g.*, to amounts credited to a Depreciation Fund Account.

The following are the recommendations of the Council of the Institute of Chartered Accountants regarding the use of the word "provision" :—

"(a) The word "provision" should cease to be used to denote amounts set aside to meet specific requirements the amounts whereof can be estimated closely ; such amounts should be grouped with creditors since they represent liabilities or accruals.

"(b) Amounts set aside to meet deferred repairs the execution of which is a contractual or statutory obligation (*e.g.*, under a dilapidations claims of a lease) should be treated as liabilities if the amounts can be determined with substantial accuracy and as provisions if the amounts cannot be so determined.

"(c) Other amounts set aside to meet deferred repairs because they are regarded as charges necessary for the correct computation of profits

should be treated as provisions, on the footing that they are closely analogous to amounts provided for renewals (which are specifically required to be treated as provisions) and differ from these in degree rather than in character."

The Council of the Institute of Chartered Accountants also recommend, on the basis of counsel's opinion, that an amount set aside aside out of profits to meet future income tax is not a liability and cannot, therefore, be treated as a provision. Such an amount should be grouped in the Balance Sheet as a reserve.

Where additions to or withdrawals from reserves and provisions have been made during the year and such transfers affect the profit and loss account, the amounts involved, if material, must be shown separately in that account. Where, however, the addition or withdrawals are capital transactions, *e.g.*, a transfer to capital reserve of a capital profit, such transactions should either appear on the face of the Balance Sheet or in a statement or report annexed thereto. The source from which the increase has been derived or the manner in which the decrease has been applied must be shown clearly.

It will be observed that the schedule requires the aggregate of provisions (other than provisions for depreciation, renewals or diminution in value of assets) to be stated. The following is the recommendation of the Council of the Institute of Chartered Accountants on this point :—

"On a proper grouping of the Balance Sheet some provisions will not be suitable for aggregation ; for example, where some provisions are current liabilities and others are not. In such cases, an 'aggregate' should be regarded as a minimum requirement intended to avoid the unnecessary disclosure of separate items which individually have no significance ; it should not be treated as a restriction operating against the presentation of a true and fair view."

It will be observed that the Act does not really define the term " capital reserve " but states what may

not be included under that heading. The term should be used to describe—

(i) reserves which cannot legally be distributed, *e.g.*, share premiums, a capital redemption reserve fund, etc., and

(ii) reserves which because of their origin or the purpose for which they are retained, are regarded by the directors as not being free for distribution through the Profit and Loss Account, *e.g.*, a sum received as compensation for damage to goodwill, a profit made on the sale of a fixed asset, to the extent that such profit is not due to past excessive provisions for depreciation.

A debit balance on Profit and Loss Account should be shown as far as possible as a deduction from the aggregate of revenue reserves. If the Profit and Loss Account debit balance exceeds the revenue reserves, the excess may be shown as a deduction from the paid up capital, the balance of which would then represent the net book value of the shareholders' interest in the assets. Alternatively, the debit balance on Profit and Loss Account may be shown on the assets side of the Balance Sheet.

(2) *The Valuation of Fixed Assets.*

The normal basis on which fixed assets should be shown in the Balance Sheet is arrived at by taking the difference between—

(*a*) the cost of the asset or, if it stands in the company's books at a valuation, the amount of the valuation ; and

(*b*) the aggregate amount provided or written off since the date of acquisition or valuation, as

the case may be, for depreciation or diminution in value.

The amount arrived at in this way will be the net amount extended in the Balance Sheet, but the aggregate of (*a*) and the aggregate of (*b*) must also each be shown thereby.

There are cases, however, where the normal basis cannot be adopted because the company's records do not provide sufficient information to enable the cost and provision for depreciation of assets acquired prior to 1st July, 1948, to be ascertained without unreasonable expense or delay. In such cases, the Act provides that the net amount at which the assets stood in the company's books at 1st July, 1948, shall be treated as if it were the amount of a valuation of those assets made at that date. This method of valuation is known as the "*net book amount basis.*"

Where the "net book amount basis" is adopted, accounting difficulties arise because additions to the fixed assets since 1st July, 1948, must be taken on the normal basis, and in most cases part of the assets acquired prior to 1st July, 1948, can also be valued on that basis. The total of any type of fixed asset may, therefore, be valued partly on one basis and partly on another. The Institute of Chartered Accountants obtained the opinion of counsel as to the manner in which a fixed asset should be stated in the Balance Sheet where the total consisted partly of a value on the net book amount basis and partly at cost. The opinion is given hereunder.

"In stating the 'method' used to arrive at the amount of the fixed assets it must in our opinion be borne in mind that the method prescribed by the Eighth Schedule, Part 1, paragraph 5 (1) is *one* method—cost or valuation, less provisions or writings off for depreciation or diminution in value—and remains *one* method even where 'the net book amount' of some assets

is treated as a valuation. It follows, therefore, that the Act is satisfied if under an asset heading with appropriate wording one aggregate figure is shown embodying both cost and valuation (including 'net book amount' where the schedule requires this to be treated as valuation) with one aggregate deduction for depreciation."

The following are suggested alternative methods of showing the position in the balance sheet:—

Method 1.

	£	£
Plant and Machinery:		
At cost (and, where figures for cost or valuation are not reasonably obtainable, at the net amount standing in the company's books on 1st July, 1948, *less* sales)	750,000	
Less: Depreciation	150,000	
		£600,000

Method 2.

	Cost, etc. £	Depreciation £	Net £
Plant and Machinery:			
At cost, *less* depreciation	600,000	125,000	
At the net amount standing in the company's books on 1st July, 1948 (where figures for cost or valuation are not reasonably obtainable) less sales and depreciation	150,000	25,000	
	£750,000	£150,000	£600,000

It will be appreciated that in order to comply with the Act, which requires the accumulated provision for depreciation to date to be shown separately on the Balance Sheet, it is essential, where the items of plant and machinery are numerous, that a company should maintain a plant ledger in order that adjustments for plant sold can be made correctly. Annual provisions

for depreciation should not be credited to the asset account but to a Provision for Depreciation Account which automatically will show the cumulative figure required for Balance Sheet purposes. When a machine is sold, the depreciation applicable thereto will be written back from the Provisions for Depreciation Account to the asset account and any profit or loss adjusted thereon.

Where a company purchases a number of assets for a lump sum without separate values being assigned to each, it is recommended by the Council of the Institute of Chartered Accountants that—

> "a value should be allocated to each asset or class of asset by the directors or other competent person in such a manner as to enable the various assets or classes of assets to be shown in the Balance Sheet at 'a valuation' and depreciation provided thereon. Otherwise it will not be possible during the useful life of those assets to conform to the intentions of paragraph 5 (1), Part I, Eighth Schedule."

The Act does not define "valuation" for the above purposes and the Council of the Institute recommend—

> "(*a*) To satisfy the general requirement to show a true and fair view, an indication of the date and source of a valuation should wherever practicable be given in the Balance Sheet.
>
> "(*b*) The description 'valuation' should not be applied to any assets dealt with on the net book amount basis unless it is made clear that it is a notional valuation adopted in accordance with the requirements of the Act."

If depreciation or replacement of any fixed asset is provided for by some method other than a depreciation charge or provision for renewals, the Profit and Loss Account must show or state the method adopted. If no depreciation charge or provision for renewals is made for any asset or class of assets, this fact must be stated in the Profit and Loss Account, and this is so, even though it may not normally be regarded as necessary to provide for depreciation of the asset in qeustion, *e.g.*, freehold land.

Provisions for renewals should be shown separately in the Balance Sheet and not as a deduction from the assets concerned. Amounts set aside to meet the *increased cost* of replacing assets are reserves and not provisions.

Overseas companies, *i.e.*, companies incorporated outside Great Britain but which have a place of business within Great Britain must, by virtue of Section 410, Companies Act, 1948, make out a Balance Sheet and Profit and Loss Account in every calendar year, and, if the company is a holding company, group accounts, in such form, and containing such particulars and including such documents, as under the provisions of the Act (subject, however, to any prescribed exceptions) it would if it had been a company within the meaning of the Act, have been required to make out and lay before the company in general meeting, and deliver copies of those documents to the registrar of companies.

A company registered under the law relating to companies for the time being in force in Northern Ireland and having provisions in its constitution which would, if it had been registered in Great Britain, entitle it to rank as a private company, need not comply with the foregoing provisions if there is delivered to the registrar a certificate signed by a director and by the secretary of the company that, had section one hundred and twenty-nine of, and the Seventh Schedule to, the Act extended to Northern Ireland, it would at the date of the certificate have been an exempt private company.

If any such document as is mentioned above is not written in the English language, there must be annexed to it a certified translation thereof.

(3) *Loans to Directors and Officers of the Company.*

Section 190, Companies Act, 1948, prohibits a company from making loans to a director of the company or to a director of its holding company or from entering into any guarantee or providing any security in connection with a loan to such a director made by some other person. This prohibition does not apply, however, to an exempt private company or to a loan—

(*a*) made by a subsidiary company to the holding company which is its director;

(*b*) made to a director for the purpose of providing him with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or to enable him properly to perform his duties as an officer of the company;

(*c*) made by a company whose ordinary business includes the lending of money provided such loan is made in the ordinary course of business.

A loan can only be made to a director under (*b*) above if—

(i) it has received the prior approval of the company in general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or

(ii) it is on condition that, if the approval of the company is not given at or before the next following annual general meeting, the loan shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting.

Where the approval of the company is not given as required by any such condition, the directors authorising the making of the loan, or the entering into the guarantee, or the provision of the security, will be jointly and severally liable to indemnify the company against any loss arising therefrom.

A company may make loans to its officers, other than directors, but by Section 197 details thereof must be given in the accounts to be laid before the company in general meeting showing—

(*a*) The amount of any loans made during the company's financial year to—

(i) any officer of the company; or

(ii) any person who, after the making of the loan, became during that year an officer of the company;

by the company or a subsidiary thereof or by any other person under a guarantee from or on a security provided by the company or a subsidiary thereof (including any such loans which were repaid during that year); and

(*b*) the amount of any loans made in manner aforesaid to any such officer or person as aforesaid at any time before the company's financial year and outstanding at the expiration thereof.

The above information need not be given in the amounts in the case of—

(*a*) a loan made in the ordinary course of its business by the company or a subsidiary thereof, where the ordinary business of the company or, as the case may be, the subsidiary, includes the lending of money; or

(*b*) a loan made by the company or a subsidiary thereof to an employee of the company or subsidiary, as the case may be, if the loan does not exceed two thousand pounds and is certified by the directors of the company or subsidiary, as the case may be, to have been made in accordance with any practice adopted or about to be adopted by the company or subsidiary with respect to loans to its employees ;

not being, in either case, a loan made by the company under a guarantee from or on a security provided by a subsidiary thereof or a loan made by a subsidiary of the company under a guarantee from or on a security provided by the company or any other subsidiary thereof.

If the requisite information regarding loans to officers of the company is not given in the accounts, it is the duty of the auditors of the company to include in their report a statement giving the particulars required, so far as they are reasonably able to do so.

It may be difficult to determine in all cases what payments to or indebtedness by officers will come under this provision as to " loans " ; in many instances, particularly in the case of private companies, officers of the company may have a current account with the company, or may purchase goods from the company for which they do not pay for some considerable time. It is suggested that where officers discharge obligations incurred in the ordinary course of trading with the company, within the usual term of credit allowed to other persons, any amounts of this nature outstanding could be grouped with other sundry debtors, but every other case should be carefully scrutinised by the

auditor, especially in view of the obligation upon him to supply in his report any information not sufficiently disclosed.

The auditor must never overlook the fact that it is illegal for a company to lend money or provide security, etc., to enable the borrower to purchase shares in the company or in its holding company, except when—

(*a*) lending money is part of the ordinary business of the company and the loan is made in the ordinary course of business; or

(*b*) the loan is made to trustees to enable them to purchase shares to be held for the benefit of employees; or

(*c*) the loan is made to employees of the company, other than directors, to enable them to acquire shares as beneficial owners (Section 54).

(d) The Directors' Report.

A report by the directors of the company must be attached to every Balance Sheet laid before the company in general meeting (Section 157 (1)).

The report must include information as to the state of the company's affairs, the amount, if any, which the directors recommend should be paid by way of dividend; and the amount, if any, which they propose to carry to reserve.

The report must also deal, so far as is material for the appreciation of the state of the company's affairs and not in the opinion of the directors harmful to the business of the company or of its subsidiaries, with any change during the financial year, in the nature of the company's business or in that of its subsidiaries.

Mention must also be made of any change in the classes of business in which the company has an interest.

§ 11.—The Inclusion of the Balance Sheet in the Annual Summary.

By Section 127, Companies Act, 1948, companies are obliged to include in their Annual Return a written copy, certified by a director and by the secretary of the company to be a true copy, of every Balance Sheet, including every document required by law to be annexed thereto, laid before the company in general meeting during the period to which the return relates. There must also be included with the return a certified copy of the auditor's report on, and of the report of the directors, accompanying such Balance Sheet. These provisions do not apply to *exempt* private companies.

§ 12.—Directors.

Every company, other than a private company, registered after 1st November, 1929, must have at least two directors, and every company registered before that date, and every private company must have at least one director (Section 176). Every company must have a secretary, and where there is only one director such director cannot also be the secretary (Section 177).

(a) Liability of Directors to account.

The relation between the directors of a company and the company itself has been defined by Lord Selbourne, in *G.E.Rly. Co.* v. *Turner* (1872, 8 Ch. 149), when he said : " The directors are the mere trustees

or agents of the company—trustees of the company's money and property; agents in the transactions which are entered into on behalf of the company." As such, directors are liable to account to the company for the assets which have come into their hands or are under their control.

Directors therefore occupy a fiduciary position, and cannot make any profit out of the company beyond the remuneration to which they are entitled.

If a director is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company, he must disclose the nature of his interest at a meeting of the directors.

The auditor should carefully note any contracts entered into by the company with its directors and he should satisfy himself that any requirements of the auditors in connection therewith have been complied with.

In the event of any loans having been made to directors, it should be seen that these transactions are *intra vires* the company, and that the security is adequate; otherwise the auditor should refer to the matter in his report.

Directors may sustain liability for misfeasance or breach of trust under Section 333 of the Companies Act, 1948. Where a claim is made, or there is reason to believe that a claim will be made for misfeasance or breach of trust, he may apply to the Court for relief under Section 448.

It used not to be unusual for a clause to be included in the Articles indemnifying directors and other officers (including auditors) from the consequences of negligence, not amounting to wilful negligence, in the performance of their respective

duties, but under Section 205 such provisions are void. Nothing in Section 205 will, however, operate to deprive any person of any exemption or right to be indemnified in respect of anything done or omitted to be done by him whilst any such provision was in force; and a company may still indemnify a director or other officer against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour, or in which he is acquitted, as the case may be, or in connection with a successful application for relief under Section 448.

Directors may also be liable for offences committed in the following circumstances:—

(1) Under Sections 43 and 44, Companies Act, 1948, for authorising the issue of a prospectus containing untrue statements.

(2) Under Section 438, Companies Act, 1948, for wilfully making false statements in reports, certificates, Balance Sheets, etc.

(3) Under Section 329 of the same Act, for destruction, mutilation, falsification, etc., of books, papers or securities of a company being wound up.

(4) Under Section 328, for various offences analogous to those applicable to a debtor under Section 154 of the Bankruptcy Act, 1914, as amended by the Bankruptcy Act, 1926.

(5) Under Section 331, where proper books of account have not been kept by the company throughout the period of two years immediately preceding the commencement of the liquidation of the company or the period

between incorporation and the commencement of winding up, whichever is the shorter.

(6) Under Section 147, for failure to keep the necessary books of account for the purpose of recording the prescribed information.

(7) Under Section 332, where any business of the company has been carried on with intent to defraud creditors.

(8) Under Section 193, for failure to disclose payment for loss of office, etc.

(9) Under Section 5 of the Perjury Act, 1911, for making false statements in accounts, Balance Sheets, reports, etc.

(10) Under Sections 82—84 of the Larceny Act, 1861, for defrauding the company, or concealing any fraud by falsification or destruction of books, accounts, etc.

(11) Under Section 20 of the Larceny Act, 1916, for fraudulent conversion of the property of the company.

(b) Remuneration of Directors.

Directors are not entitled to remuneration unless the Articles of the company provide for the payment thereof, or the members in general meeting resolve to pay such remuneration. The auditor should therefore examine the Articles to ascertain whether the remuneration is fixed thereby, and, if not, he must ascertain by reference to the members' minute book whether any resolution has been passed under which the directors are entitled to remuneration.

Directors' remuneration may take the following forms :—

(1) A sum, fixed by the Articles, divisible among the directors each year, as they may themselves determine.

(2) A sum, fixed by the Articles, payable to each director, and an additional sum payable to the chairman.

(3) A fee, fixed by the Articles, to be paid for each meeting attended, or the remuneration payable to the directors as a whole to be apportioned according to the attendances of each.

(4) A sum equal to a percentage on the profits of the company, either with or without the addition of a fixed remuneration.

(5) An amount voted by the company in general meeting, and divisible between the directors according to the resolution.

In order to vouch the remuneration paid under the first mèthod, the auditor should examine the Articles and the resolution of the directors determining in what manner the remuneration is to be divided.

In the second case, the authority would be found in the Articles, and no resolution of the directors is necessary.

In the third case, the auditor should examine the Directors Attendance Book, and see that the fees paid to each director are properly calculated according to the number of his attendances.

In the fourth case, the Articles must be examined by the auditor in order to ascertain the manner in which the percentage of the profits payable to the directors is to be arrived at. Unfortunately, in many

cases, the Articles do not clearly define the manner in which the percentage is to be calculated, and in cases of dispute it is advisable that the definition given in the Articles should be amplified by resolution of the company in general meeting. Where the directors are entitled to a percentage on the *net profits* of the company, the question arises as to whether the term " net profits " means the profits after or before charging such remuneration. Although such percentage is a charge so far as the members are concerned, it is an appropriation of the profits so far as the directors are concerned, and should, in the absence of clear indication in the Articles to the contrary, be based on the profits *before* charging the percentage.

This view was confirmed by the Court in *Edwards* v. *Saunton Hotel Ltd.* (1942, T.R. 359).

A further point arises in connection with the treatment of income tax. Income tax is legally an appropriation of profits, but so much thereof as cannot be recouped from members, debenture holders or others, is treated as a charge in the accounts of the company. It has been decided that where a manager of a company is entitled to a percentage of net profits, income tax must not be charged before arriving at the sum upon which the commission is to be calculated (*Johnston* v. *Chestergate Hat Manufacturing Co.*, 1915, L.J. 84, Ch. 915). It was held in this case that income tax is part of the net profits available for dividends, and the phrase " net profits " in the particular case in question was defined in the agreement to mean " the net sum available for dividends as certified by the auditors. . . . . ." The Court followed the ruling in *Attorney-General* v. *Ashton Gas Company*

(1907, L.J. 73, Ch. 673) where it was held that income tax is part of the profits, viz., such part as the Revenue is entitled to take of the profits.

It will be noted that the agreement provided that the auditor's certificate of the amount upon which the commission was to be paid, was to be taken as final, but the Court held that where such a certificate is based on a wrong principle, it is not conclusive and binding on the parties.

Although income tax is not a proper deduction in arriving at the net profits, it was held in *Re Agreement of G. B. Ollivant & Co. Ltd.* (1942, T.R. 295), where a manager was entitled to a commission based on profits, that " for the purpose of drawing up the Profit and Loss Account of a trading company, excess profits tax must be deducted, if ordinary commercial practice is to be followed." By analogy, profits tax should be deducted.

Any provisions made for anticipated losses must be charged before arriving at the amount of profits on which the percentage is calculated ; but appropriations to general reserve, or reserves for equalising dividends should not be charged.

Where the remuneration is based on the *net trading profits*, losses or expenses not arising in the ordinary course of trading, income tax, or other appropriations of profit, should not be debited, but on the other hand, interest and dividends received on investments, or any profit not arising in the ordinary course of trading, should not be credited.

Remuneration based on a percentage of profits does not include a percentage of the profits made on the sale of the whole undertaking of the company

(*Frames* v. *Bultfontein Mining Co.*, 1891, 1 Ch. 140); but in the absence of special stipulations to the contrary, "profits" in cases where the rights of third parties are involved, mean actual profits, and not necessarily the profits as shewn by the Profit and Loss Account (*In re Spanish Prospecting Co.*, 1911, L.J. Ch. 210).

Where the remuneration is voted by the members in general meeting, the auditor must examine the members' minute book. Such a remuneration is in the nature of a gratuity and not an amount to which the directors are entitled by right, even although the Articles may state that the remuneration of the directors shall be fixed by the company in general meeting (*Hutton* v. *West Cork Railway Co.*, 1883, 23 Ch. D. 654).

It is a misfeasance on the part of a director to take remuneration in excess of the amount that is payable, and any directors who are parties to such payments are jointly and severally liable to refund the amount (*Leeds Estate Co.* v. *Shepherd*, 1887, 36 Ch. 809; *re Whitehall Court*, 1887, 56 L.T. 280). The company, however, can ratify the payment of remuneration in excess of that prescribed by the Articles by altering the Articles or by passing a special resolution (*Boschoek Proprietary Co.* v. *Fuke*, 1906, 1 Ch. 148).

The remuneration due to the directors is not due to them in their character as members. They are ordinary creditors for it and can rank with such as outside creditors (*Re New British Iron Co. ex parte Beckwith*, 1898, 1 Ch. 324; *re A1 Biscuit Co.*, 1899, W.N. 115); but they may not pay themselves fees in priority to outside creditors when the funds are not sufficient to pay everyone in full (*Gas Light Improvement Co.* v. *Terrall*, 1870, 10 Eq. 168); or in case of

the insolvency of the company pay up their calls and utilise the money so obtained to pay their own fees (*Re Washington Diamond Mining Co.*, 1893, 3 Ch. 95).

The question as to whether a director is entitled to any remuneration if he vacates office during the currency of a year has given rise to much discussion and several decisions have been given. Where the directors were entitled to a lump sum, no apportionment was allowed to a director who vacated office during the year (*Salton* v. *New Beeston Cycle Co.*, 1899, 1 Ch. 775); and where the provision was that each director should be paid the sum of £300 per annum, no apportionment was allowed (*McConnell's Case*, 1901, 1 Ch. 729): and again, where the words were "The sum of £300 per annum per director" (*Inman* v. *Ackroyd*, 1901, 1 K.B. 613). These decisions, however, followed that of the Court of Appeal in *Swabey* v. *Port Darwin Gold Mining Co.* (1889, 1 Meg. 385), which apparently was erroneously reported, and they cannot, therefore, be regarded as final. It would appear that if the provision is "at the rate of ——— per annum," apportionment would be allowed. Owing to the uncertainty involved, it has become customary, since these cases were decided, to provide in the Articles that the remuneration shall be apportionable. Table "A" of the Companies Act, 1948, provides that directors' remuneration shall be deemed to accrue from day to day.

Sometimes directors waive the whole or a portion of their fees. In such a case the minute book would contain a resolution of the board to that effect, although all the directors would require to be present at the meeting, and to vote on the resolution. A verbal agreement between the liquidator of a company

and the directors, and by the directors mutually with each and all the others to forego directors' fees is valid (*West Yorkshire Darracq Agency, Ltd.* (in Liqdn.) v. *Coleridge*, 1911, L.J., K.B., 1122).

The general provisions of the Act regarding the disclosure in the accounts of remuneration paid to directors and what is regarded as emoluments was dealt with in § 10 (*b*) of this chapter. Tax free payments to directors are prohibited by Section 189, which provides as follows:—

(1) It shall not be lawful for a company to pay a director remuneration (whether as director or otherwise) free of income tax or of income tax other than sur-tax, or otherwise calculated by reference to or varying with the amount of his income tax or his income tax other than sur-tax, or to or with the rate or standard rate of income tax, except under a contract which was in force on the eighteenth day of July, nineteen hundred and forty-five, and provides expressly, and not by reference to the Articles, for payment of remuneration as aforesaid.

(2) Any provision contained in a company's Articles, or in any contract other than such a contract as aforesaid, or in any resolution of a company or a company's directors, for payment to a director of remuneration as aforesaid shall have effect as if it provided for payment, as a gross sum subject to income tax and sur-tax, of the net sum for which it actually provides.

It will thus be observed that if a director is voted remuneration of, say, £1,000 free of income tax, the words "free of income tax" must be ignored and the amount of £1,000 will represent the gross sum payable to the director from which income tax under the provisions of P.A.Y.E. will be deducted in the usual way.

(c) Payments to Directors for loss of office.

A company may not make a payment to a director as compensation for loss of office or in consideration of his retirement from office, unless particulars thereof are disclosed to and approved by the members of the company (Section 191).

If a company transfers the whole or part of its undertaking, no payment in connection with such transfer may be made to a director as compensation for loss of office or as consideration for his retirement, unless particulars of the proposed payment are disclosed to the members and approved by them. If a director receives such a payment without the requisite approval of the company, he is deemed to hold the amount in trust for the company (Section 193).

(d) Directors' Qualification.

Unless the Articles provide that he shall do so, a director need not hold any share qualification, but, where this is required, the auditor should ascertain that the director has duly acquired the shares within two months after appointment, or such shorter time as may be fixed by the Articles, as required by Section 182, Companies Act, 1948. If the qualification is not so acquired, the office of director is vacated. A director who acts without acquiring his qualification shares may be entitled to his remuneration up to the date at which the office becomes vacated (*Salton* v. *New Beeston Cycle Co.*, 1899, 1 Ch. 775).

The company may by ordinary resolution remove a director before the expiration of his period of office. Special notice must be given to the members of any resolution to remove a director, and the director has similar rights to make written representations to the members as those given to auditors who are to be removed or replaced (Section 184).

Section 185, Companies Act, 1948, provides that no person shall be capable of being appointed a director of a company if at the time of appointment he has attained the age of seventy. The section also provides

that any director reaching the age of seventy shall vacate his office at the conclusion of the annual general meeting commencing next after he attains the age of seventy. A director who is in office at the commencement of the Companies Act, 1948, however, may continue to hold office until the third annual general meeting after the commencement of the Act, if he has attained the age of seventy before the commencement of that meeting. The provisions of this section do not apply to a private company unless such company is a subsidiary of a public company.

Notwithstanding the above provisions, a person over seventy years of age may be appointed a director or may continue to act as such after reaching that age if—

(*a*) his appointment was made or approved by the company in general meeting and special notice was given of the resolution, the notice stating the director's age ; or

(*b*) in the case of a company registered after 1st January, 1947, the Articles exclude the provisions ; or

(*c*) in the case of a company registered prior to 1st January, 1947, a special resolution is passed to alter the Articles and to exclude the provisions.

Any person appointed or proposed to be appointed director of a company which is subject to the above provisions, must give notice to the company when he attains the retiring age applicable to him under the Act or the Articles of the company.

Any person failing to comply with this section will be liable to a fine not exceeding five pounds a day

for every day in which failure to notify, continues or in which he acts as director after his appointment has been terminated or become invalid by reason of his age.

The Act makes no provision for vacation of office in any other circumstances, but Table "A" and the Articles of most companies make specific regulations on this point. Vacation of office takes place automatically upon the specified event occurring and remuneration will cease accordingly (*Bodega Co., Ltd.*, 1904, 1 Ch. 276). Subject to the Articles, a director may not hold any other office of profit under the company, and the acceptance of such an office will vacate the directorship ; the appointment of a director as trustee for debenture holders, receiving a remuneration for his services, is sufficient to disqualify him (*Astley* v. *New Tivoli Co.*, 1889, 1 Ch. 151).

Clause 85, Table "A" provides :—

(3) A director may hold any other office or place of profit under the company (other than the office of auditor) in conjunction with his office of director for such period and on such terms (as to remuneration and otherwise) as the directors may determine and no director or intending director shall be qualified by his office from contracting with the company either with regard to his tenure of any such other office or place of profit or as vendor, purchaser or otherwise, nor shall any such contract, or any contract or arrangement entered into by or on behalf of the company in which any director is in any way interested, be liable to be avoided, nor shall any director so contracting or being so interested be liable to account to the company for any profit realised by any such contract or arrangement by reason of such director holding that office or of the fiduciary relation thereby established.

(4) A director, notwithstanding his interest, may be counted in the quorum present at any meeting whereat he or any other director is appointed to hold any such office or place of profit under the company or whereat the terms of any such appointment are arranged, and he may vote on any such appointment or arrangement other than his own appointment or the arrangement of the terms thereof.

(5) Any director may act by himself or his firm in a professional capacity for the company, and he or his firm shall be entitled to remuneration for professional services as if he were not a director; provided that nothing herein contained shall authorise a director or his firm to act as auditor to the company.

(e) Directors' Travelling Expenses.

Unless the Articles specifically provide, a director is not entitled to travelling expenses incurred in attending board meetings, which are presumably covered by his remuneration (*Young* v. *Naval and Military Co-operative Society*, 1905, 1 K.B. 687). It is, however, common to find a provision in the Articles entitling directors to their travelling expenses incurred in attending board meetings, and power to make such payments are given by clause 76 of Table "A," which also authorises the payment by the company of expenses incurred by directors in travelling on the business of the company.

The vouchers for payments of this nature do not usually contain details of the expenditure, and it is advisable that all such payments, being to the directors themselves, should form the subject of a minute. Where the auditor considers the payment excessive, and is unable to obtain particulars as to how they are arrived at, he should refer to the matter in his report to the members.

Power is usually given in the Articles for the directors, by resolution, to vote additional remuneration to any director who is called upon to travel on business for the company. Any such payments, being authorised, are in order, but the auditor should see that they are separately shown in the accounts presented to the members.

(f) Managing Directors.

Table "A" gives power for the directors to appoint one of their number as managing director or manager and fix his remuneration, which may be by way of salary, or commission, or participation in profits, or partly in one way and partly in another, and the Articles of most companies make similar provision. Where a managing director has been appointed under such powers, the resolution of the board appointing him and fixing his remuneration must be examined by the auditor, and the remuneration vouched according to the basis on which it is payable.

A managing director is not a clerk or servant of the company within the meaning of Section 319, Companies Act, 1948, and consequently is not entitled to preferential treatment in respect of arrears of salary or commission in the event of winding-up (*Newspaper Proprietary Syndicate*, 1900, 2 Ch. 349). A secretary of the company, however, who devotes the whole of his time to the services of the company, can claim preferential rights (*Cairney* v. *Bach*, 1906, 2 K.B. 746); and so also can a director in respect of employment where he is authorised by the Articles to accept such employment in the company (*Re Beeton & Co., Ltd.*, 1913, L.T. 160).

(g) Secretary.

Every company must have a secretary and a sole director shall not also be secretary (Companies Act, 1948, Section 177). Table "A" provides that the secretary shall be appointed by the directors for such term, at such remuneration, and upon such conditions as they may think fit, and any secretary so appointed may be removed by them.

§ 13.—Minute Books.

(a) Directors' Minute Book.

Under Section 145, Companies Act, 1948, every company must cause minutes of all proceedings at meetings of directors or managers to be entered in a minute book. Any minute purporting to be signed by the chairman of the meeting, or by the chairman of the next succeeding meeting, is evidence of the proceedings.

The auditor should peruse the minute book and should see that all minutes which he is utilising as evidence of transactions are duly signed, and that the names of the directors present at the meeting have been inserted. The auditor should refer to the minute book in vouching all transactions other than those connected with the usual trading operations.

The following are instances of transactions of a special nature :—

(1) Allotment of shares.

(2) Adoption of contracts.

(3) Power to utilise the company's seal.

(4) Making calls.

(5) Forfeiting shares.

(6) Appointment and remuneration of managing director, manager, secretary, or other officials.

(7) Appointment of auditors prior to annual general meeting, or to fill a casual vacancy, and their remuneration.

(8) Authorisation of capital expenditure.

(9) Resolution to pay interim dividends where such are *intra vires*.

(10) Payment of travelling expenses to directors or special remuneration.

(11) Adoption of accounts.

(12) Adoption of directors' report to members and recommendations as to division of profits.

(b) Members' Minute Book.

Under Section 145 of the Act quoted above, minutes must be made of all proceedings and resolutions at members' meetings, and entered in the members' minute book. The auditor should examine the minutes of each meeting, particularly with reference to the following matters :—

(1) Adoption of accounts.

(2) Appropriation of profits by way of dividends, and amounts placed to reserve, etc.

(3) Remuneration voted to directors.

(4) The election of auditors and their remuneration.

(5) Any resolutions affecting the accounts.

It is most advisable that minute books should take the form of bound books, but by Section 436, Companies Act, 1948, any other system may be adopted, provided that adequate precautions are taken to guard against falsification and to facilitate its discovery.

§ 14.—Register of Directors' Shareholdings, etc.

Section 195, Companies Act, 1948, provides that :—

(1) Every company shall keep a register showing as respects each director of the company (not being its holding company) the number, description and amount of any shares in or debentures of the company or any other body corporate, being the company's

subsidiary or holding company, or a subsidiary of the company's holding company, which are held by or in trust for him or of which he has any right to become the holder (whether on payment or not):

Provided that the register need not include shares in any body corporate which is the wholly-owned subsidiary of another body corporate, and for this purpose a body corporate shall be deemed to be the wholly-owned subsidiary of another if it has no members but that other and that other's wholly-owned subsidiaries and its or their nominees.

(2) Where any shares or debentures fall to be or cease to be recorded in the said register in relation to any director by reason of a transaction entered into after the commencement of this Act and while he is a director, the register shall also show the date of, and price or other consideration for, the transaction:

Provided that where there is an interval between the agreement for any such transaction and the completion thereof, the date shall be that of the agreement.

(3) The nature and extent of a director's interest or right in or over any shares or debentures recorded in relation to him in the said register shall, if he so requires, be indicated in the register.

(4) The company shall not, by virtue of anything done for the purposes of this section, be affected with notice of, or put upon inquiry as to, the rights of any person in relation to any shares or debentures.

(5) The said register shall, subject to the provisions of this section, be kept at the company's registered office and shall be open to inspection during business hours (subject to such reasonable restrictions as the company may by its articles or in general meeting impose, so that not less than two hours in each day be allowed for inspection) as follows:—

(*a*) during the period beginning fourteen days before the date of the company's annual general meeting and ending three days after the date of its conclusion it shall be open to the inspection of any member or holder of debentures of the company; and

(*b*) during that or any other period, it shall be open to the inspection of any person acting on behalf of the Board of Trade.

In computing the fourteen days and the three days mentioned in this subsection, any day which is a Saturday or Sunday or a bank holiday shall be disregarded.

(6) Without prejudice to the rights conferred by the last foregoing subsection, the Board of Trade may at any time require a copy of the said register, or any part thereof.

(7) The said register shall also be produced at the commencement of the company's annual general meeting and remain open and accessible during the continuance of the meeting to any person attending the meeting.

(8) If default is made in complying with the last foregoing subsection the company and every officer of the company who is in default shall be liable to a fine not exceeding fifty pounds; and if default is made in complying with subsection (1) or (2) of this section, or if any inspection required under this section is refused or any copy required thereunder is not sent within a reasonable time, the company and every officer of the company who is in default shall be liable to a fine not exceeding five hundred pounds and further to a default fine of two pounds.

(9) In the case of any such refusal, the court may by order compel an immediate inspection of the register.

Where the auditor performs a share transfer audit he should see that all transactions by the directors in the company's shares as disclosed thereby are properly recorded in the register of directors' shareholdings, etc. It is not considered necessary, however, in the course of the ordinary audit of the company's accounts that the auditor should attempt to check the accuracy of the entries made in the register.

§ 15.—Reserve Funds.

The nature of reserves and the distinction between reserves and provisions have been discussed in Chap. IV, § 8, where the question as to whether a general reserve should be retained in the business or invested specifically outside the business is considered; and it was there pointed out that although the term "reserve fund" is frequently employed when the reserve is not represented by specific investments outside the business, but by general assets, it is preferable to designate a reserve so represented "reserve account," and to confine the use of the term "reserve fund" to those cases where there are specific investments representing the fund.

Most companies have power to put profits to reserve before payment of any dividend, and clause 117 of Table "A" provides that the directors may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as reserve or reserves, which shall, at the discretion of the directors, be applicable for any purpose to which the profits of the company may be properly applied, and pending such application, may be employed in the business of the company, or invested in such investments as the directors may think fit.

It is very desirable in most cases that a reserve fund should be accumulated, and in some cases the Articles provide that a fixed percentage of the profits must be retained each year and placed to reserve until a certain sum has been so accumulated, and where this is the case, the auditor should see that the provision is duly carried out. Such compulsory provision, however, is unusual, and commonly the Articles leave the matter to the discretion of the directors. Where such discretion is given, it is a matter for the directors to determine how much of the profits of any one year they shall put to reserve before recommending the payment of a dividend, even though the result of their action may be to prevent payment of any dividend on founders' shares (*Fisher* v. *Black and White Publishing Co.*, 1901, 1 Ch. 174); or preference shares (*Bond* v. *Barrow Hœmatite Steel Co.*, 1902, 1 Ch. 358).

In addition to appropriations of profits, exceptional profits may be placed direct to reserve. Where a sinking fund has been provided for the redemption of debentures, the amount to the credit of this account,

when the redemption of the debentures has been accomplished, should be transferred to the credit of reserve and will be represented by the assets formerly subject to the charge contained in the debentures.

A reserve fund accumulated out of profits may be utilised in any manner in which the profits of the company may be applied and can be drawn upon for payment of dividends or to meet exceptional losses. Where a loss has been incurred on revenue account, such loss can be made good by a transfer from the reserve so long as the transfer is disclosed in the Profit and Loss Account. Any loss arising from diminution in value of the fixed or capital assets of the company may be written off against the Reserve Account.

Where the book value of the fixed assets is less than the real value and it is desired to write up the value of such assets in the Balance Sheet, the increase should be placed to the credit of a Capital Reserve Account, since it will not be available for revenue purposes, but any subsequent loss in connection with these assets may be charged against such reserve. Before passing any entries recording the appreciation of assets in this manner the auditor should ascertain why the revaluation has been made, and by whom, and satisfy himself that it is *bonâ fide.* Under no circumstances should such an appreciation be taken to the credit of revenue, unless it can be shown to have arisen by reason of excessive depreciation having been written off in the past; even then it is not desirable to credit the Profit and Loss Account, as this would have the effect of unduly increasing the profits of the current year, and the amount should preferably be carried to the credit of reserve.

It would appear, however, that a *bonâ fide* increase in the value of fixed assets can be utilised to extinguish the debit balance on Profit and Loss Account, thus leaving current profits available for the payment of dividend (*Ammonia Soda Company* v. *Chamberlain*, 1918, L.J. 87, page 193). This decision is more fully referred to in Chapter VIII.

Where the assets representing a reserve are permanently employed in the business of the company, it is sometimes desired to capitalise a portion or the whole of the reserve, and this can be done by declaring a bonus or dividend payable out of the reserve, free of income tax, by the issue of fully paid shares.

Many prosperous companies have accumulated very large reserves, which have been used in the business, with the result that the rate of dividend paid on the issued share capital does not correspond with the rate actually earned on the capital employed in the business, and it has been thought advisable, in many cases, to bring the issued capital into a proper relation with the capital employed, by capitalising a large portion of the reserves in the way above indicated.

In recent years, however, few companies have been able to make bonus issues. Under the Defence (Finance) Regulations, 1939, such issues were prohibited and even when the regulations were relaxed in 1947, the duty of £10 per cent. imposed upon the value of the bonus by Section 60, Finance Act, 1947, was regarded by most directors as too prohibitive to justify an issue.

Where an issue is contemplated, it should be seen that the articles of the company permit of such treatment; if not, they should be altered by special resolution; and that the company has sufficient

unissued shares to enable this operation to be performed, as otherwise it will be necessary to increase the capital of the company for this purpose.

If the members do not have an unconditional right to take their dividends or bonuses in cash, should they wish to do so, this operation will probably require a contract to be filed with the Registrar of Companies, constituting the title of the allottees to the shares, under Section 52, Companies Act, 1948.

A resolution having been passed by the company authorising this procedure, the directors should pass a resolution declaring the dividend or bonus payable out of reserve by way of the issue of fully-paid shares, and a contract should be entered into between the company and a nominee on behalf of the members under which the shares should be allotted. Arrangement should be made for dealing with the allotment of fractions of shares.

Sometimes this method is utilised for the purpose of discharging wholly or partly the uncalled liability on shares already issued. In this case the procedure is to declare the bonus or dividend out of reserve, and at the same time to make a call on the shares to a corresponding amount. If the company's Articles give power for the call to be set off against the dividend, this can be done, but, if no power is given, the individual members must authorise the company to retain the monies due to them for dividend or bonus in payment of the call. This can most conveniently be done by the indorsement of the dividend warrant by each individual member, such indorsement being drawn to operate as an authority to the company to apply the amount thereof in the manner indicated.

A dividend so distributed has been regarded as equivalent to a dividend paid in cash (*Rance's Case*, 1871, 6 Ch. 104); and it would therefore seem that there is no obligation to file any contract in a case of this sort.

A reserve fund accumulated out of profits retains its revenue nature in the event of liquidation, and is divisible amongst the members in the proportion in which they are entitled to share the profits. If the Articles provide that the preference shareholders are entitled to profits in certain proportions and there are any arrears of preference dividend, preference shareholders will be entitled to such arrears out of the reserve fund (*Bishop* v. *Smyrna & Cassaba Railway*, 1895, 2 Ch. 265); but where the right of such preference shareholders to dividends only accrues after a resolution to pay such dividend has been passed by the directors, and the company goes into liquidation before any such resolution is passed, the preference shareholders will have no claim against the reserve fund in respect of arrears of dividend (*Crichton's Oil Co.*, 1901, 2 Ch. 184; 1902, 2 Ch. 86).

The ultimate distribution of surplus assets after repaying to members the nominal amount of their capital, whether such surplus is represented by a reserve fund or not, must depend upon the rights of the respective classes of members as defined in the Articles.

If, however, the Articles are silent on the point, all the shareholders, preference and ordinary, are entitled to rank *pari passu* in the distribution of surplus assets (*Re William Metcalfe & Sons*, 1933, Ch. 142).

§ 16.—Secret or Internal Reserves.

Prior to the operation of the Companies Act, 1948, many companies created secret or internal reserves, and in some cases the practice was abused by the directors, with the result that shareholders were presented with most misleading financial statements.

A secret reserve may be defined as a reserve, the existence of which is not disclosed on the face of the Balance Sheet. Such reserves were usually created in one or other of the following ways :—

(1) By writing down assets, such as investments, freehold and leasehold property, or plant and machinery, below their real value.

(2) By creating excessive provisions for bad debts or other contingencies.

(3) By charging capital expenditure to revenue.

(4) By undervaluing stock-in-trade.

(5) By writing down goodwill.

(6) By the creation of a reserve for contingencies, either by direct transfer from revenue or by the accumulation of exceptional profits not credited to revenue, and including such reserve with *liabilities* on the Balance Sheet.

(7) By ignoring appreciation which has taken place in the value of fixed assets.

The object of creating a secret reserve was to enable a company to avoid violent fluctuations in its profits or dividends and so prevent any disturbance of confidence or undue variation in the value of its shares. In the case of concerns, such as banking companies, whose whole existence depends upon the credit they enjoy and the confidence they inspire, it was found essential to have recourse to reserves of this nature particularly those created as in (6) *supra.*

The objections urged against the existence of internal reserves were :—

(1) As assets were undervalued, the Balance Sheet did not show the true position of affairs.

(2) The balance of profit available for dividends was diminished, and consequently the members possibly received a lower rate of dividend than otherwise would have been the case.

(3) The reduction in the amount of divisible profits, and the diminution of the value of assets appearing on the Balance Sheet, might have caused the market value of the shares to be less than it otherwise would have been.

(4) Such reserves might have been utilised in an improper manner by the directors for the purpose of manipulating the company's shares in the market.

(5) Where secret reserves were drawn upon to maintain dividends and this was not disclosed, the fact that the revenue for the period for which the dividend was paid was insufficient for the purpose was probably not known to the members. The true trading results of a period were thus obscured.

Where reserves of this nature were material in amount, there was no question that the Balance Sheet did not exhibit a true and correct view of the state of affairs, and although the actual state of affairs might have been much better than it appeared to be, it was desirable for the auditor to refer to the matter in his report to the members by indicating that the values placed upon certain assets were considerably less than their actual values, or that the amount of the

provision made for bad debts or for other purposes, appeared to be in excess of what was required. Such a reference protected the auditor, and it was not necessary for him to disclose the extent of the reserves in question. In many cases, however, these secret reserves were made with the direct consent of the members by means of appropriations of profit recommended by the directors and approved by the company in general meeting.

The argument that the balance of divisible profits was diminished and that the members possibly received a lower dividend than otherwise would be the case, could not be maintained if the directors were acting in a *bonâ fide* manner, and in the interests of the company generally, since the directors ought not to recommend the payment of any dividend in excess of what they, in their judgment, consider should be paid. Where the requisite moneys were not retained in the business by the operation of a secret reserve, it was necessary to have recourse to an open reserve, or the carrying forward of a larger credit balance on the Profit and Loss Account.

The fact that the published profits appeared to be less than they actually were, or that the assets appeared at a lower value than otherwise would be the case, did no doubt have some effect in reducing the market value of the shares, where the fact of the existence of such secret reserves was not known in the market. In the majority of cases, however, and particularly in the case of banking companies, the fact that such reserves existed was well known to the bulk of the members and was to a large extent taken into account in the value at which the shares stood in the market.

Even where these facts were not generally known, however, so long as the directors were acting in the general interests of the company, they did not need to concern themselves with the individual interests of temporary members.

The gravest objection which could be raised to the creation of secret reserves was that they might be utilised in an improper manner for the personal advantage of the directors or their friends. It was quite possible, by charging capital expenditure to revenue, or by largely undervaluing stock-in-trade, or by including reserves among liabilities, or over-providing for expenses or contingencies, etc., so to reduce the profits in any one year and the consequent dividend, as to cause the shares of the company to fall in value considerably. A corresponding rise would take place at some subsequent period when the profits were allowed to appear again at their proper amount, but in the meantime the company's shares might have been dealt in very advantageously by persons commanding an intimate knowledge of the position.

The creation of a secret reserve by writing down the value of the goodwill is open to no objection, since this asset is of a purely hypothetical value, and the fact that it stands at a low figure in the Balance Sheet, although the company may be earning large profits, will only tend to strengthen the general position, and increase the value of the shares rather than otherwise.

The judgment of Mr. Justice Wright in the *Royal Mail* case (which is discussed in greater detail in Chapter X) was perhaps the first warning to auditors that when secret reserves were utilised for the payment of dividends in years in which no profits were made for

this purpose, the fact that recourse has been had to secret reserves must be mentioned by them in their report to the members. In the words of the learned judge, "If the accounts from which dividends and expenses are paid are being fed by undisclosed reserves it seems difficult to see how an auditor can possibly discharge his duty of giving a true and accurate view of the company's affairs without mentioning and drawing attention to this fact, which may be almost of vital importance as indicating the state of the company's affairs."

The case of *Newton v. Birmingham Small Arms Co., Ltd.* (1906, 2 Ch. 378), is important in connection with this subject. The company desired to adopt additional Articles giving power to the directors to set aside amounts out of profit, without disclosing the fact, for the purpose of constituting an internal reserve fund, which should not be shown or disclosed on the Balance Sheet. The shareholders were not to have the right to obtain information from the directors as to the amount or application of this fund, which might be invested in any way the directors thought fit, or utilised in any manner which the directors, in their absolute discretion might consider would serve, protect, or advance the interests of the company, or preserve or promote the value of the undertaking, assets or goodwill of the company. The auditors were to be allowed access to the accounts relating to such fund, and it would be their duty to ascertain that the application thereof was in accordance with the provisions of the Articles, but they were *not* to disclose any information with regard to the internal reserve to the shareholders or otherwise.

It was held by Buckley, J., that, in-so-far as restrictions were placed upon the auditors in the matter

of their report to the members, the Article was *ultra vires,* as being inconsistent with the Statute, which places no limitations on the nature of the information which the auditors might disclose to the members.

By virtue of the provisions of the Companies Act, 1948, the subject of secret reserves is now largely one of academic interest only. If there has been appreciation in the value of fixed assets which is unrecorded, or goodwill has been written down below its true value, the company has to this extent a secret reserve, but with such exceptions, for all practical purposes, secret reserves can no longer be created. The methods formerly adopted for the creation of secret reserves are no longer possible for the following reasons:—

(*a*) The amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves must be shown in the Profit and Loss Account (Eighth Schedule, paragraph 12 (*e*)).

(*b*) The amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions *and not applied for the purposes thereof* must be shown in the Profit and Loss Account (Eighth Schedule, paragraph 12 (*f*)).

(*c*) The aggregate amount provided or written off since the date of acquisition or valuation of fixed assets must be shown separately on the Balance Sheet (Eighth Schedule, paragraph 5 (*b*)).

(*d*) The aggregate amounts of capital reserves, revenue reserves and provisions respectively

must be shown separately on the Balance Sheet (Eighth Schedule, paragraph 6).

(*e*) Where any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before 1st July, 1948, or any amount retained by way of providing for any known liability is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess must be treated as a reserve and not as a provision and the amount of such excess thus disclosed (Eighth Schedule, paragraph 27 (2)).

The fact that secret reserves are essential in the case of certain types of companies is recognised by the Act, which provides that items (*a*) to (*d*) above, shall not apply to banking and discount companies or to assurance companies within the meaning of the Assurance Companies Acts, 1909 to 1946. The Board of Trade also have power, on the application or with the consent of a company's directors, to modify in relation to the company any of the above requirements, and in particular the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that it is not required in the public interest and would prejudice the company.

§ 17.—Taxation.

It is not within the province of this work to consider in detail the question of taxation, either from a legal point of view, or from the practical aspect as affecting accounts.

It is not the duty of the auditor to prepare computations for taxation purposes and to submit them to the Inland Revenue, although he frequently is called upon to do so in practice. The preparation of such computations should be undertaken by competent officials of the company, but where the auditor is asked to do such work, it will be performed by him as an accountant and not as auditor.

The auditor must, however, check the taxation computations in order to satisfy himself that the reserve or provision for taxation shown in the Profit and Loss Account is correct. It must be remembered that the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits has to be shown separately in the Profit and Loss Account. It will readily be appreciated what a misleading impression could be created by a Balance Sheet in which there was an inadequate or grossly excessive provision for taxation, and as the auditor is required to report that the Balance Sheet shows a true and fair view of the state of the company's affairs, this duty cannot be discharged without proper consideration being given to the taxation liabilities included therein.

Where it appears that the company is entitled to make a claim or claims for the recovery of tax, the auditor should satisfy himself that these have been or will be made, and vouch the receipt of the refund in due course.

The income tax year of assessment commences on 6th April and extends to the following 5th April, but the assessment is based, normally, on the profits of a preceding accounting period, and the tax is payable, in the case of a company, on 1st January in the year of

assessment. Provision should, therefore, be made when preparing the accounts, in respect of a company's income tax liability, although in the past some difference of opinion has existed as to the basis on which such provision should be calculated. The liability for income tax, which may be regarded as having accrued to the date of a Balance Sheet, is the proportion of the liability for the current income tax year, which is attributable to the period from 6th April in that year to the date of the Balance Sheet. Thus, if the accounts of a company are made up to 30th September, 1948, the minimum, or legal, provision for income tax should be the proportion of the income tax for the year 1948-9, which relates to the period 6th April to 30th September, 1948. Such a provision, however, takes no account of the balance of the liability for the current fiscal year (*i.e.*, from 1st October, 1948, to 5th April, 1949), although the whole of the tax will be payable on 1st January, 1949. Moreover, the profits of the current accounting year will ultimately form the basis of an assessment to income tax for the following fiscal year, and it may be considered prudent to provide not only for the full amount of the tax liability for the current income tax year, but also for the tax which will be payable on the current year's profits. Unless such provision is made, cases may arise where the profits earned in a succeeding period will bear a disproportionate charge for taxation, or may even be insufficient to meet it. Although, therefore, no objection can be taken to the provision for income tax conforming to the minimum legal requirements, it is preferable that provision be made for the *whole* of the tax for the current fiscal year, and *also* for the estimated tax on the current

accounting year's profits, which will be assessed in the following fiscal year. This practice has received the approval of the Council of the Institute of Chartered Accountants in their recommendation to members.

The amount set aside to meet the tax for the current fiscal year will, if the amount can be ascertained exactly, be shown in the Balance Sheet as a current liability, but if the amount cannot be determined with reasonable accuracy, it will be treated as a provision. Amounts set aside to meet future income tax must be treated as reserves and grouped therewith in the Balance Sheet.

The basis on which the amount, if any, set aside for United Kingdom income tax is computed must be shown on the Balance Sheet or by way of a note or in a statement or report annexed thereto. In the Profit and Loss Account the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing, where practicable, between income tax and other taxation, must be shown (Eighth Schedule, Companies Act, 1948).

The Income Tax Account of a company should be debited with all income tax paid, with any tax suffered on income received under deductions of tax, and with the provisions, reserve or liability for income tax carried forward at the end of the accounting period. The account should be credited with the balance brought forward from the previous period, and with any tax recouped by deduction from debenture and loan interest, ground rents, patent royalties and other

annual charges. The balance of the account should then be transferred to Profit and Loss Appropriation Account.

With regard to dividends payable by a company, it may be contended that although these are paid under deduction of tax, the true amount of the appropriation of profits is the gross amount of these dividends, the tax deducted therefrom merely being a recoupment of tax paid by the company on so much of its profits as are distributed in the form of dividends. If this view were taken, it would be quite correct to debit the *gross* dividends to Appropriation Account, and credit Income Tax Account with the tax deducted therefrom. The more modern view, however (which has received the support of the Council of the Institute of Chartered Accountants), is that as the company's liability to income tax is computed on the full amount of its profits, irrespective of the dividends paid thereout, the balance on the Appropriation Account, after debiting the full income tax liability, represents the fund available for payment of the *net* dividends, and only such net amount should therefore be debited to Appropriation Account. Annual charges, such as debenture interest, royalties, etc., should, however, be charged gross, as the company is, in effect, merely the agent for collection from the payee of the tax thereon, and such tax must be accounted for to the Revenue either as part of the tax liability on the company's income, or by way of a separate assessment under Rule 21 of the General Rules, Income Tax Act, 1918.

In addition to income tax, provision must also be made for profits tax, but as this liability is based on the profits of the accounting period for which it is assessed, no controversy can arise as to the extent of the provision—the full liability should be provided for.

CHAPTER VIII

DIVISIBLE PROFITS AND DIVIDENDS

§ 1.—The Ascertainment of Profits.

The proper ascertainment of profits in the case of a company is a matter of very great importance, affecting the rights and interests of various parties in different ways. If the profits shown in the accounts have been arrived at incorrectly, and are in excess of the actual profits, and further, if they have been distributed in dividend, the effect may be that the dividend will have been paid out of capital in whole or in part, and that the capital fund contributed by the members will not remain intact.

Similarly, such a proceeding might affect the rights of debenture holders, since the dividend so paid away would have the result of depleting the assets which form their security.

If the improper distribution of dividends has so depleted the funds of the company that the remaining assets are insufficient to provide for the payment of ordinary creditors, the interests of the latter are obviously affected; while the directors of the company may make themselves personally liable to account for any dividends paid out of capital.

Further, there may be third parties entitled to a share of the profits, such as directors, managers, or others, receiving a percentage thereon.

Where the profits shown are more than the actual profits, such persons might receive more than they are entitled to, while on the other hand where the profits

shown are less than the actual profits, such persons may be entitled to take their proportion of the actual profits.

If the total assets of a business are valued at the commencement of the year, the difference between this sum and the total of liabilities and capital at that date represents a surplus or deficiency, as the case may be. If a similar valuation is made at the end of the year and the surplus is found to have increased, or the deficiency decreased, such difference, subject to any appropriations of profit or adjustments of capital, is the profit for the period, while if the surplus has decreased, or the deficiency increased, such difference is the loss for the period.

It is clear that the amount of profit so arrived at is dependent upon the method employed in determining the value of the assets.

If all the assets were valued at the amounts they are expected to realise if the business were closed down, a heavy loss would almost certainly be shown. This method therefore is not adopted, but the valuation is made on the basis of a going concern. It is necessary, however, to distinguish between the various classes of assets, since if fixed assets representing capital expenditure, such as freehold land, rise in value, and this increase is taken into account, it represents an unrealised increment which may never materialise into a tangible profit.

Fixed assets, therefore, are generally valued at their cost price, less a proper allowance for the depreciation which has arisen as a result of their being utilised in carrying on the business.

Similarly, current assets should not be valued above cost, as this would involve taking profit before it is realised; the proper basis of valuation being cost or realisable value, whichever is the lower.

In effect, therefore, the profits may be said to be the excess of current income for a given period over current expenditure, after making good any loss sustained by fixed or current assets during that period in the process of earning such income.

It does not follow, however, in the case of a company, that profits so arrived at are necessarily divisible profits, and the Courts have held in certain instances that it may not be necessary to make good expired capital expenditure before arriving at the profits out of which dividends may be payable; in each case the provisions of the Memorandum and Articles of Association and their validity must be considered. It may be found, on the other hand, that various appropriations must be made from the profits before any balance is available for distribution.

Before proceeding, however, to a detailed consideration of these cases it is important to note the following decisions dealing with the ascertainment of profits.

(a) Legal Decisions.

(1) *The Spanish Prospecting Co., Ltd.* (1910, 103, L.T. 611).

In this case the company had entered into an agreement with two men, A and B, who were to receive a salary at the rate of £41 13s. 4d. per month each, subject to the proviso that they should not be entitled to draw their salary "except only out of profits," if any, arising from the business of the company, which might from time to time be available for such purpose. Any such salary was to be cumulative, and any arrears thereon payable out of succeeding profits.

The business of the company included the purchase and sale of shares; and certain debentures which had been acquired stood in the books at no value.

The company went into liquidation while the debentures were still unsold, but they were subsequently realised by the liquidator, and it was claimed that the proceeds should be credited to the Profit and Loss Account, in order to enable A and B to receive their salaries out of the profits arising therefrom. Swinfen Eady, J., decided that a surplus on realised assets in winding-up, over and above the subscribed capital, was not a profit arising out of the business of the company; but the Court of Appeal reversed the decision, and indicated that the proceeds could be properly credited to Profit and Loss Account.

Fletcher Moulton, L.J., said:—

" . . . We start therefore with this fundamental definition of 'profits,' viz., if the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for any capital introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question. But the periodical ascertainment of profits in a business is an operation of such practical importance as to be essential to the safe conduct of the business itself. To follow out the strict consequences of the legal conception in making out the accounts of the year would often be very difficult in practice. Hence the strict meaning of the word 'profit' is rarely observed in drawing up the accounts of firms or companies. These are domestic documents designed for the practical guidance of those interested, and, so long as the principle on which they are drawn up is clear, their value is diminished little, if at all, by certain departures from this strict definition which lessen greatly the difficulty of making them out. Hence certain assumptions have become so customary in drawing up Balance Sheets and Profit and Loss Accounts that it may almost be said to require special circumstances to induce parties to depart from them. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company—such for instance, as a rise in the market value of land occupied by the company. The value assigned to trade buildings and plant is usually fixed according to an arbitrary rule, by which they are originally taken at their actual cost and are assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or in exchange. These, however, are merely variations of practice by individuals. They rest on no settled principle. They mainly arise from the sound business view that it is better to underrate than to overrate the profits, since it is impossible for you to foresee all the risks to which a business may in future be exposed. For instance, there are many sound business men who would feel bound to take account of depreciation in the value of business premises (or in the value of plant

specially designed for the production of a particular article), although they would not take account of appreciation in the same arising from like causes. . . . . But though there is a wide field for variation of practice in these estimations of profit, this liberty ceases at once when the rights of third persons intervene. . . . In the absence of special stipulations to the contrary 'profits' in cases where the rights of third parties come in mean actual profits, and they must be calculated as closely as possible, in accordance with the fundamental conception or definition to which I have referred."

This judgment is an extremely able appreciation of the methods usually put into practice in business circles for the ascertainment of profits. While it is true that the method adopted is not a mere single entry process, nevertheless the end is to ascertain the net gain shown by the Balance Sheet over its predecessor, after allowing for depreciation on the various assets.

This case, however, was concerned with the ascertainment of profits, and not with the question of divisible profits. In fact the learned judge went on to say—

"I would have it clearly understood that these remarks have no bearing upon the vexed question of the fund out of which dividends may be legally paid in limited companies. Cases such as *Verner* v. *General and Commercial Investment Trust* and *Lee* v. *Neuchatel* show that this fund may in some cases be larger than what can rightly be regarded as profits, and the decisions in these cases depend largely on the fact that there is no statutory enactment which forbids it to be so."

(2) *Re Crabtree, Thomas* v. *Crabtree* (1912, 106, L.T. 49).

The testator gave his trustees authority to carry on his business during the lifetime of his wife, and directed that the profits arising from the said business should be paid to her. The trustees, before arriving at the profits, had charged the annual sum for depreciation of machinery at the rate of 7½ per cent. on its original value in addition to the cost of repairs, and the tenant for life contended that this ought to be disallowed. The Court of Appeal held that following Swinfen Eady, J., such depreciation had been properly charged.

In the course of his judgment Cozens-Hardy, M.R., said :—

"But in the ordinary course of ascertaining the profits of a business where there is power machinery and trade machinery which is necessary in order to perform the work of the business, it is, in my opinion, essential that, in addition to all sums actually expended in repairing the machinery, or in renewing parts, that there should be also written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business, or at the profits of the business, and it is not profit until a proper sum, varying with the class of machinery, with the nature of the business, and the life of the machinery, has been written off for depreciation."

During the argument the case of *Lee* v. *Neuchatel Asphalte Co.* was referred to, and in the course of his remarks Buckley, L.J., said :—

"The only authorities referred to were those of companies formed to work a wasting property, and in such a case all profit arising from the wasting property is divisible without any deduction for the depreciation in value of the wasting property. That is because the object of the company was to acquire a wasting property and to divide all the profits. That is not so here. The profits of this business are not ascertained until a sufficient sum has been deducted to meet the depreciation of the machinery. One of the witnesses in his affidavit referred to the 'saleable value' of this machinery. That is not the right standard. Here it is the value of the machinery for the purpose of this business, not the saleable value."

It must be remembered that the business concerned in the *Crabtree Case* was not carried on by a limited company.

(3) *In Edwards* v. *Saunton Hotel Co., Ltd.* (1942, T.R. 359).

Where a director of the company was entitled to 20% of the profit "available for distribution each year," a similar conclusion was arrived at with regard to depreciation of fixed assets as in *re Crabtree,* the further direction being made that the depreciation should be calculated on the fixed instalment method, and not on the reducing instalment system, which would cause a disproportionate charge to be made against profits in the early years of the life of an asset.

In *Edwards* v. *Saunton Hotel Co., Ltd.* it was also confirmed that in ascertaining the profits Income Tax

should *not* be deducted, and that the commission should be computed on the profits *before* deducting the commission.

(4) On the other hand, it was held in *Re Agreement of G. B. Ollivant & Co. Ltd.* (1942, T.R. 295), where a manager was entitled to a commission based on profits, that Excess Profits Tax *must* be deducted before arriving at the profits, if ordinary commercial practice is to be followed.

§ 2.—Depreciation of Fixed and Current Assets.

The terms " Fixed," " Current " and " Wasting " Assets have already been defined in Chapter IV, § 5, and the treatment of depreciation on such assets from a general point of view has been considered. The legal aspect of the subject as affecting limited companies is of great importance in determining divisible profits, and has been the subject of some notable decisions. It is proposed first of all to summarise these cases, and from the consideration thereof to draw such general conclusions as may be possible.

(a) Legal Decisions.

(1) *Lee* v. *Neuchatel Asphalte Co., Ltd.* (1889, 41 Ch. 1).

Held—THAT A COMPANY, EMPOWERED TO DO SO BY ITS ARTICLES OF ASSOCIATION, MAY DISTRIBUTE DIVIDENDS WITHOUT MAKING GOOD THE DEPRECIATION OF *wasting* ASSETS.

This action was brought by Mr. Lee on behalf of himself and all the ordinary shareholders of the Neuchatel Asphalte Company, with the object of obtaining an injunction to prevent the directors of that company from distributing a dividend to the preference shareholders until depreciation of the

company's property had been provided for. The Articles of the company provided that the directors should not be bound to reserve moneys for the renewal or replacement of any lease, or of the company's interest in any property or concession; though as a matter of fact the company did from time to time write off considerable amounts, but had not made any such provision in the year during which the profit which it was proposed to distribute had arisen.

It may be remarked that in the case of a leasehold mine which cannot be exhausted during the term of the lease, the loss is continuous whether the mine be worked or not, and is a question of time and not of output; while in the case of a freehold mine the loss is one of output only. The learned judge in the remarks quoted below on this point did not refer to the element of time.

Lindley, L.J., in the course of his judgment said (Acct. L. R. 1889, 26):—

"The respondent company was formed for the purpose of working certain asphalte mines of which it had got a lease. It was quite obvious that with respect to such a property, every ton of stuff got out of that which was bought with capital represented a portion of capital. It was said that a division of the profit arising from the sale of such was a return of capital. If that was so, it is not, at all events, such a return of capital as is prohibited by the Company Acts. There is nothing in any of the Company Acts prohibiting anything of the kind. . . . It has been very judicially and properly left to the commercial world to settle how the accounts were to be kept. The Acts do not say what expenses are to be charged to Capital Account and what to Revenue Account. Such matters were left to the shareholders: they may or may not have a Sinking Fund or a Deterioration Fund, the Articles of Association may or may not contain regulations on these matters, if they do, the regulations must be observed; if they do not, the shareholders can do as they like, so long as they do not misapply their capital. In this case one of the Articles provides that the directors shall not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession. . . . Now, the Companies Act, 1862, does not require the capital to be made up if lost, and it does not prohibit payment of dividends so long as the assets are of less value than the capital called up, nor does it make loss of capital a ground for winding-up. But if a company is formed to acquire or work property of a wasting nature, *e.g.*, a mine, quarry, or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property

over the cost of working it may be divided amongst the shareholders; and this is true, although some portion of the property itself is sold, and in one sense the capital is thereby diminished. If it is said that such a course involves payment of dividends out of capital, the answer is that the Acts nowhere prohibit such a payment as is here supposed. The proposition that it is *ultra vires* to pay dividends out of capital is very apt to mislead, and must not be understood in such a way as to prohibit honest tradings. It is not true, as an abstract proposition, that no dividends can be properly declared out of moneys arising from the sale of property bought by capital. But it is true that if the working expenses exceed the current gains, profits cannot be divided, and that if in such a case capital is divided and paid away as dividend, the capital is misapplied, and the directors implicated in the misapplication may be compelled to make good the amount misapplied. . ."

(2) *Bolton* v. *Natal Land and Colonisation Co., Ltd.* (1892, 2 Ch. 124).

Held—THAT A COMPANY MAY DECLARE A DIVIDEND OUT OF CURRENT PROFITS WITHOUT NECESSARILY MAKING GOOD LOSS OF CAPITAL.

The Natal Land Company, in 1882, had charged against revenue £70,000 in respect of a bad debt which had been incurred, and, at the same time, adjusted the Profit and Loss Account by crediting to it practically the same sum in respect of an increase in value attributed to lands held by them.

In 1885 a profit was made and a dividend subsequently declared, and the plaintiff thereupon brought this action for restraining the payment of the dividend. His argument was that the value of the land in the books was now in excess of the true value, and that the difference between the 1882 book value and the actual value should be written off against profits before anything could be appropriated for the purposes of dividend.

The Court held that, assuming a part of the capital had in fact been lost, and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of

the land in 1882, and credited the increase to the profit of that year in the manner described, did not place it under any obligation to bring into account in every subsequent year the increase or decrease in the value of its lands; and that, having regard to the case of *Lee* v. *Neuchatel Asphalte Company, Limited,* it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

It might appear that this case supported the suggestion that a company might write up the value of its capital assets to conceal a revenue loss without being obliged to charge against revenue any decrease subsequently found to have occurred owing to excessive appreciation in the past; but it should be remembered that the Court did not have before it the question as to whether the bad debt should have been charged against revenue or not, the learned Judge specifically stating that this point was not raised on the pleadings.

(3) *Verner* v. *General and Commercial Investment Trust, Ltd.* (1894, 2 Ch. 239).

Held—THAT, SUBJECT TO ITS ARTICLES, A TRUST COMPANY MAY DISTRIBUTE A DIVIDEND OUT OF THE EXCESS OF CURRENT INCOME OVER CURRENT EXPENDITURE, WITHOUT MAKING GOOD LOSS OF CAPITAL.

This trust company had issued share capital to the extent of £600,000, and had borrowed £300,000 on the security of debenture stock. The proceeds of these issues had been invested in various securities authorised by the Memorandum of Association. The market value of such securities at the date of the account was £654,776, depreciation having thus occurred to the extent of about £240,000, of which it was estimated that about £75,000 represented an

amount which there was no prospect of recovering within any reasonable period of time. During the company's last financial year the current income from investments had exceeded the current expenditure by more than £23,000, and the question for the Court to decide was whether such excess could be utilised for the purposes of dividend without taking into account the loss of capital to the amount of £75,000.

Lindley, L.J., in the course of his judgment, said :—

"The broad question raised by this appeal is whether a limited company which has lost part of its capital, can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of. . . . There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact, either before or after the winding-up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special Article or contract there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard-and-fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends, so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law. . . . But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets, regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. The same observation applies to the payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it, will be a payment of a dividend out of capital within the meaning of the

prohibition which I have endeavoured to explain. . . . Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case, to divide such excess without deducting the capital which forms part of it, will be contrary to law. . . ."

(4) *Wilmer* v. *McNamara & Co., Ltd.* (1895, 2 Ch. 245).

Held—THAT A COMPANY CAN DECLARE A DIVIDEND OUT OF CURRENT PROFITS, WITHOUT MAKING GOOD DEPRECIATION OF FIXED ASSETS.

This company made a profit for the year ended 30th June, 1894, of £5,816 12s. 6d., before making any provision for depreciation in respect of the value of the leases, goodwill, or plant. Depreciation had been provided on these assets to a considerable extent in earlier years, but no provision was made during the year in question. A resolution was passed by the company to distribute the above-mentioned profit in payment of a dividend to the preference shareholders. This action was taken on behalf of the ordinary shareholders to restrain the directors from giving effect to the resolution, on the ground that until the loss of capital had been made good no dividends ought to be paid.

Stirling, J., in the course of his judgment, refusing the injunction asked for, said :—

"Clause 117 of the company's Articles of Association provides that 'no dividend shall be payable except out of the profits arising out of the business of the company.' What are these profits ? . . . Apart from the use of the word 'profits' in clause 117, there is nothing in the Articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up. Further, the Articles appear to contemplate 'profits' as the excess of receipts over all expenditure properly attributable to the year. It is necessary, however, to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of 'fixed' capital or of 'floating' or 'circulating' capital, and on this point I am of opinion that it is to be treated as loss of 'fixed'

capital. It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago at a certain cost, could now be made at a much smaller cost. Having regard to the remarks of Lindley, L.J., in *Lee* v. *Neuchatel Asphalte Company* (*supra*) I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction."

(5) *Dovey* v. *Cory* (*National Bank of Wales case*, 1901, A.C. 477).

Held—THAT A DIRECTOR, IF HE ACTS BONÂ FIDE IS ENTITLED TO RELY ON THE OFFICERS OF THE COMPANY TO PREPARE TRUE AND HONEST ACCOUNTS.

This was an appeal from the decision of the Court of Appeal. It was sought to make the director liable in respect of alleged misfeasance for paying dividends out of capital.

Wright, J., had ordered the respondent to pay £54,787, being £37,000, the aggregate amount of dividends paid to the shareholders in 1887, 1888, 1889, and part of the dividend of 1890, and as to the balance, interest at 5 per cent. per annum on each of the dividends, holding that these dividends were in fact paid out of capital. Such dividends had been paid without making proper provision for bad debts; had these bad debts been written off there would have been no profits available for dividend. The Court of Appeal relieved the respondent of liability on the ground that he had been deceived by persons he was entitled to trust, and that the dividends were not in fact paid out of capital; utilising for the latter point the arguments advanced in the *Lee* v. *Neuchatel* series of cases.

The House of Lords decided the case purely on the question as to whether the director concerned was or was not justified in reposing confidence in the officials

of the company, and did not feel themselves called upon to deal with the question as to whether the dividends had or had not in fact been paid out of capital.

Although, however, the House of Lords did not actually give their decision on this point, remarks were made by the Lord Chancellor (Lord Halsbury) and Davey, L.J., in the course of their judgments, which clearly showed that they were not at all inclined to agree with the deductions drawn in the Court of Appeal from the *Lee* v. *Neuchatel* and other cases; and consequently doubts have been cast upon the finality of those decisions.

The Lord Chancellor said :—

"If I assume, as I do, that Mr. Cory acted upon representations made to him which he believed, and which as coming from the officers of the bank to whom he was, in my judgment, justified in giving credit, the discussion of whether the dividends actually paid were or were not properly divisible, has no bearing on Mr. Cory's liability, and I am very reluctant to give any opinion upon it, inasmuch as the question may arise when it may be necessary to decide it. I deprecate any premature judgment. My Lords, I am, as I have said, very reluctant to enter into a question which for the reasons I have given does not arise here, and into which the Court of Appeal has entered at some length. The only reason why I refer to it at all, is lest by silence I should be supposed to adopt a course of reasoning as to which I am not satisfied that it is correct. I doubt very much whether such questions can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question what may be treated as profits and what is capital. Even the distinction between fixed and floating capital, which in an abstract treatise like Adam Smith's 'Wealth of Nations' is appropriate enough, may with reference to a concrete case be quite inappropriate. It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution. . . . On the one hand, people put their money into a trading concern to give them an income, and the sudden stoppage of all dividends would send down the value of their shares to zero, and possibly involve its ruin. On the other hand, companies cannot at their will and without the precautions enforced by the statute reduce their capital; but what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve. When the time comes that these questions come before us in a concrete case we must deal with them, but until they do, I, for one, decline to express an opinion not called for by the particular facts before us, and I am the more averse to doing so because I foresee that many matters will have to be considered by men of business which are not altogether familiar to a Court of Law."

Davey, L.J., said :—

"I desire to express my dissent from some propositions of law which were laid down in the Court of Appeal, and upon which your Lordships thought it right to hear the respondent's counsel. The learned Judges seem to have thought that a joint stock company, incorporated under the Companies Acts, may write off to capital, losses incurred in previous years, and may in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the Capital Account. If this proposition be well founded it appears to me that a company whose capital is not represented by available assets need never trouble itself to reduce its capital, with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends out of current receipts. My Lords, it may be that I have misapprehended the statement of law intended to be made by the learned Judges in the Court of Appeal. I think that is possible, because I find that in *Verner* v. *General and Commercial Investment Trust* (1894, 2 Ch. 124), 'Perhaps,' Lord Lindley says, 'the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk or lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law.' I reserve my opinion as to the effect of an actual and ascertained loss of part of the company's fixed capital. . . . But, subject to this observation, I think that the statement of law in the passage I have quoted is not open to objection, and it is only because the learned Judge appears to me to have departed from it in his judgment in the present case that I have troubled your Lordships with these remarks."

(6) *Bond* v. *Barrow Hœmatite Steel Co., Ltd.* (1902, 1 Ch. 358).

Held—THAT WHERE THE ARTICLES GIVE POWER TO PUT TO RESERVE BEFORE THE PAYMENT OF A DIVIDEND, PREFERENCE SHAREHOLDERS CANNOT COMPEL DIRECTORS TO DECLARE A DIVIDEND WITHOUT MAKING SUCH RESERVES AS THEY CONSIDER NECESSARY.

The Profit and Loss Account of this company for the year 1900 showed a balance of £157,605 12s. 11d., which was provisionally carried forward. No depreciation had been written off the amounts at debit of land, buildings, works, fixed plant, and mining leases for some years, and on a revaluation being made it appeared that a considerable loss had been sustained, and application was made to the Court for reduction

of capital. This was dismissed on the ground that the alleged loss was not proved to the satisfaction of the Court, and an action was subsequently taken by certain preference shareholders to compel the company to pay their dividends out of the credit balance on Profit and Loss Account, without making good the loss stated to have been sustained.

Farwell, J., gave judgment for the company, on the ground that the preference shareholders could not compel directors to declare a dividend without making such reserves as they considered necessary, but he added some further remarks on the question of the application of the *Lee* v. *Neuchatel* series of cases, which are of some importance.

He said :—

"It has been proved to my satisfaction . . . that the company has sustained an actual ascertained and realised loss of capital to an amount exceeding £200,000, and has also lost capital by estimate and valuation to an amount exceeding £50,000. The various sums claimed by the plaintiffs as available to pay their dividends amount to about £240,000. If, therefore, these ascertained and estimated losses have to be made good before any dividend can properly be paid, there are obviously no funds out of which to pay dividends. The defendants allege and the plaintiffs deny that the company are bound to make good these losses before paying any dividend. The question is one of very considerable difficulty on the authorities, but the result of these authorities is, in my opinion, that there is no hard-and-fast rule by which the Court can determine what is capital and what is profit. . . The real question for determination, therefore, is whether there are profits available for distribution, and this is to be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses. . . . Now in the present case the £200,000 realised loss arises by the surrender of the leases of certain mines, by the pulling down of certain furnaces, and on the sale of certain cottages. The company is a smelting company on a very large scale, and for the convenience of its works and by way of economy they acquired the leases of the surrendered mines in order to supply themselves with their own ore instead of buying it as required. The ore was used exclusively for the purposes of the company's works. The mines were drowned out and the cost of pumping them out was prohibitive. The company, therefore, surrendered the leases, pulled down the blast furnaces, and sold the cottages connected therewith. Now the evidence before me is all on one side. The plaintiffs called none, and Sir David Dale and the defendants' other witnesses all agree that in a company of this nature these items ought to come into the account before any profit can be said to be earned, and my own opinion

coincides with theirs, inasmuch as I think that the money invested in those items is properly regarded in this company as circulating capital. Suppose the company had bought enormous stocks of ore sufficient to last for ten years, it could hardly be said that the true value of so much of this as remained from time to time ought not to be brought into the Balance Sheet, and I can see no difference for the purpose of the account between ore *in situ* and ore so bought in advance. The blast furnaces and cottages are mere accessories to the ore, and resemble a building for burning the stores bought in advance already mentioned. There is more difficulty about the remaining £50,000. I think that the onus is on the plaintiff to show that it is fixed capital, and that in a company of this nature such fixed capital may be sunk or lost. They have not done this, and the evidence, so far as it goes, is the other way. But this is not an actual loss, but depreciation by estimate. The plaintiffs really relied on *Lee* v. *Neuchatel Asphalte Company* as an authority for this proposition as a universal negative—viz., 'that no company owning wasting property need ever create a depreciation fund.' In my opinion that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets. The company's assets were larger than at its formation, and the Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund. For instance, I cannot think that it would be right for the defendant company to purchase out of capital the last two or three years of a valuable patent and distribute the whole of the receipts in respect thereof as profits, without replacing the capital expended in purchase. It is for the Court to determine in each case on evidence whether the particular company ought, or ought not, to have such a fund. There is no doubt as to the opinion of the witnesses in this case, and further, the opinion of the directors cannot be altogether disregarded. The Courts have, no doubt in many cases, overruled directors who proposed to pay dividends, but I am not aware of any case in which the Court has compelled them to pay when they have expressed their opinion that the state of the accounts does not admit of any such payment. In a matter depending on evidence and expert opinion it would be a very strong measure for the Court to override the directors in such a manner."

(7) *Ammonia Soda Co.* v. *Chamberlain* (1918, L.J. 87, Ch. 193).

Held—THAT IT IS NOT NECESSARILY ILLEGAL FOR DIRECTORS OF A COMPANY TO PAY DIVIDENDS OUT OF THE PROFITS OF THE COMPANY DURING A CURRENT YEAR WITHOUT MAKING GOOD EXISTING DEFICIENCIES IN PAID-UP CAPITAL, OR WITHOUT WRITING OFF A DEBIT TO THE COMPANY'S PROFIT AND LOSS ACCOUNT, OCCASIONED BY LOSSES IN PREVIOUS YEARS.

The Profit and Loss Account of this company in the year 1911 showed a debit balance of £19,028.

This amount arose by debiting to that account at a time when the company's gross trading profit was insufficient to provide for the purpose certain sums for depreciation of buildings, plant and machinery, and also for directors' fees and mortgage and debenture interest.

In 1908, a boring made by the company to reach water for use in the company's works, failed in that purpose, but showed a new bed of rocksalt, of a thickness of about 666 feet, which was previously unknown. This discovery was considered to increase the value of the company's property, and the directors obtained a report from two of their number which advised that their land should be valued at the increased figure of £79,166, and its value was raised in the Balance Sheet of 31st July, 1911, from £63,246 to £83,788 by the addition of a sum of £20,542. This sum was credited to a Reserve Account and used to cancel £12,990 of the debit of £19,028 in the Profit and Loss Account, the remainder being written off out of net profits. For the thirteen months ending 31st January, 1912, the net profit made by the company was £13,030, and for the twelve months ending 31st January, 1913, £15,669. From September, 1912, to April, 1915, dividends amounting to £13,116 were paid on the preference shares of the company. In-so-far as these dividends were paid before providing for the £12,990, the proportion of the debit balance on the Profit and Loss Account referred to above, it was claimed that they were paid out of capital and that the directors were liable to repay them. The Court of Appeal held that the revaluation of the property was *bonâ fide* and that the directors were not liable to refund any of the dividends. The facts were not, in any way, concealed from the shareholders, and the treatment

adopted had been clearly drawn to their attention by the auditors in their report.

In the course of his judgment, Swinfen Eady, L.J., said :—

"The plaintiffs contend that, although net profits were earned during the period they were not available for dividend, and cannot really be considered 'profits,' as in the earlier period of the company's history, a loss had been incurred, and they contend that until such loss has been first made good there cannot be any profits in the real true sense of the word. In my judgment, this argument is unsound and has been exposed again and again. The Companies Acts do not impose any obligation upon a limited company, nor does the law require it, that it shall not distribute as dividend the clear net profit of its trading unless its paid-up capital is intact, or until it has made good all losses incurred in previous years. . . . . Counsel for the appellants invited the Court to lay down that wherever there was a debit to the Profit and Loss Account, irrespective of the way in which it arose, of the stage in the company's operations, and of the nature and business of the company, it was illegal to divide profits subsequently earned without first writing off out of those profits the amount of the debit. To do so would be to fall into the error which Lord Macnaghten pointed out should be avoided, and would only serve to harass and embarrass business men, and impose upon companies a burden which Parliament has abstained from casting upon them. The directors in this case were of opinion that no capital had been really lost, and they were of opinion that the value of the land and works as a going concern had been increased, as a result of their boring and exploratory work, to a considerably greater amount than £19,028. . . . The result of increasing the value at which the land stood was to give a credit which would have enabled the debit of £19,028 to be written off. Part of it was, however, actually written off out of subsequent net profits. Now, the debit consisted in part of a nominal depreciation in the fixed assets of the company, buildings, plant and machinery, and as regards the balance, it consisted of sums paid out of the subscribed capital of the company for mortgage and debenture interest, and directors' fees, there not being sufficient trading profits to provide these amounts. The transaction was carried out with the full approval of the shareholders in general meeting, and in all honesty and good faith. The dividends complained of, paid out of net earnings in the subsequent years, were not paid out of capital, but out of profits, and the defendants are, in my opinion, under no liability whatever to repay the same, or any part. . . ."

Warrington, L.J., said :—

"There is, however, one accepted restriction on the powers of companies incorporated under the Companies Acts, namely, that they must not, under the guise of dividends or in any other way, return to their shareholders money subscribed for their shares, unless it be with the sanction of the Court under the appropriate statutory provisions. It has been asserted in this case, not for the first time, that there is a further restriction—suggested to be a corollary of the rule I have just mentioned—which would make it illegal for a company to pay dividends out of the profits of a current year,

unless it first makes good deficiencies in paid-up capital occasioned by losses in previous years; or, to put the contention in a broader form, no dividends can properly be paid out of profits so long as there are losses previously incurred and not made good. In my opinion this alleged restriction has no foundation in law. . . . I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss ; the nature of the business and the amount of the loss may be such that no honest and reasonable man of business would think of paying dividends without providing for it. In such a case, I apprehend the Court would take the view that a payment which no honest and reasonable man of business would think it right to make could not properly be made by directors."

(8) *Stapley* v. *Read Bros. Ltd.* (1924—40, T.L.R. 442).

Held—THAT THE COMPANY IS NOT PRECLUDED FROM PAYING DIVIDENDS OUT OF CURRENT PROFITS WHERE A DEBIT BALANCE ON PROFIT AND LOSS ACCOUNT HAS BEEN WRITTEN OFF BY THE RESTORATION OF GOODWILL AS AN ASSET AT AN AGREED FAIR VALUE, GOODWILL HAVING PREVIOUSLY BEEN COMPLETELY WRITTEN OFF OUT OF PROFITS.

In 1918 the company wrote off the balance of Goodwill Account which was then standing at £51,000, against a Reserve Account which had been built up out of profits. In 1921 and 1922 there were losses resulting in a debit balance on Profit and Loss Account of £25,500.

In 1923 a profit of £13,430 was made, but this was not sufficient to pay the dividend on the preference shares for 1923, and the arrears for 1921 and 1922. The directors proposed to re-debit Goodwill Account with £40,000 on the ground that this was a conservative value to be placed on goodwill, and to credit this sum to a Reserve Account. The Reserve Account was then to be utilised for writing off the debit balance of £25,500 on Profit and Loss Account, the remainder, with the profit for 1923, to be used for payment of the dividends on the preference shares.

A shareholder thereupon applied for an injunction to restrain the directors from treating as profits

available for distribution any profits previously used for writing down the company's assets and subsequently written back.

In the course of his judgment, Russell, J., said :—

" . . . . If they had retained goodwill as an asset in their balance sheet, and if, instead of writing off its value out of profits, they had carried those profits to a goodwill depreciation reserve fund, they would have been at liberty at any time to distribute those profits, at all events to the extent by which the amount of such a reserve fund exceeded the amount of the actual depreciation. . . . . . .

" Does it make any difference that they have kept their accounts in another form, and that, instead of placing the profits to a reserve account, they have purported to apply them in writing off a corresponding amount of the value of the goodwill? The answer seems to me to depend upon the further question: Have the company finally and irrevocably capitalised those profits so as to disentitle themselves for ever afterwards from restoring them to reserve and from dealing with them as profits? No doubt the accounts showing the particular methods adopted were approved every year by the shareholders in general meeting, but I am not satisfied that the shareholders thereby intended, or bound themselves, for all time and in all circumstances to give up their claims to these profits and to treat them as capital only.

" In my opinion, unless there is anything in the Companies (Consolidation) Act, 1908, or in the constitution of the company to prohibit it, the shareholders may, if they think fit, write back to profit account so much of the depreciation written off goodwill as has proved to have been in excess of proper requirements "

(b) Legal Decisions considered.

The authority of the judgments of the Court of Appeal in the *Lee* v. *Neuchatel* series of decisions was regarded as somewhat shaken by the remarks of Lord Halsbury and Lord Davey in the House of Lords Appeal in *Dovey* v. *Cory*, quoted above; and the remarks of Farwell, J., in the *Bond* v. *Barrow Hæmatite* case further indicate that these decisions must be taken as applying to the specific cases concerned, and that in future each case must be taken in connection with the particular circumstances surrounding it. In the case of *Ammonia Soda Co.* v. *Chamberlain*, the Court of Appeal strongly confirmed the principles laid down by its predecessors in the *Lee* v. *Neuchatel*

series of cases, and clearly indicated that if these were to be disturbed, it must be done by some higher Court than the Court of Appeal.

Accordingly it becomes a matter of some difficulty to attempt to summarise the legal position as regards the necessity of providing depreciation in respect of fixed or wasting assets.

Before considering as to how far it is wise to rely upon the authority of the judgments in actual practice, it is desirable to note the financial distinction between the result of the judgment in the *Neuchatel* case, and that in the *Verner* case. The latter followed the former from a legal point of view, but the financial position of a trust company is fundamentally different from that of a mining company, although the Court took no cognisance of this distinction.

In the *Neuchatel* case the principal property of the company consisted of a leasehold mine, which was gradually exhausted in the process of earning income. The capital contributed by the shareholders was sunk in acquiring this particular property, and the question was whether it was *necessary* to make good the waste before distributing a dividend out of the excess of current income over current expenditure. The Articles of the company gave power to distribute dividends without so making good, and from the judgment of the Court, and subsequent decisions, it is clear that this Article was not regarded as *ultra vires* the Companies Acts. The contention, therefore, that any company in similar circumstances desiring to act in this manner must first have power under its Articles to do so falls to the ground, since had the Neuchatel Company's Article been *ultra vires* it could have afforded no authority to the company to distribute dividends without providing for the depreciation.

In the case of a company formed for the express purpose of working a leasehold mine, it is probable that the shareholders of the company would expect it to go into liquidation on the exhaustion of its principal asset. If this were so, assuming that the Development Account were properly treated, and a sufficient balance of working capital maintained, the moneys retained out of profits representing any further provision for depreciation could not be utilised by the company, but would necessarily have to be invested in outside securities. These investments would gradually accumulate, and if the calculations on which the depreciation was based were correct, on the final exhaustion of the asset the company would be in possession of funds sufficient to pay back in full to the shareholders the nominal value of capital contributed by them. Though this may be considered as theoretically desirable, shareholders might not necessarily desire this course to be taken, but might prefer to receive larger dividends during the life of the mine. In a case of this sort, where the company is expected to wind up on the exhaustion of its principal asset, the matter becomes one of policy, and there would seem to be no reason, financial or otherwise, why the general body of shareholders should not receive the bulk of their proportion of capital by way of dividends, should they desire to do so.

The *Verner* case, however, although it was decided on the precedent of the *Neuchatel* case, presents a totally different aspect from the practical point of view.

The company was a trust company, and the investments had very largely depreciated. Although the Court held that the investments of a trust company are to be regarded as fixed assets, they cannot be called wasting assets, and therefore are

not in the same category as a leasehold mine or a cemetery.

The shareholders of a trust company do not anticipate that the securities in which the bulk of their capital has been invested are assets of a wasting nature. The company is not expected to wind up within any definable period; and no doubt the majority of the shareholders would expect their capital to be returned to them in full on liquidation. On the other hand, shareholders in companies of this nature, rely upon obtaining regular income, and to be deprived of dividends for a long period while capital loss is made good, would prove a tremendous hardship in many cases.

This case, therefore, cannot be regarded as similar to the *Neuchatel* case from a financial point of view, notwithstanding the fact that the Court treated the question of depreciation in the same manner. Lindley, L.J., said that although a proceeding might be perfectly legal, it might be opposed to sound commercial principles, but that the Court had only to consider the legality or illegality of the company's action.

The same Judge made some important remarks on the distinction between "fixed" and "current" assets, when he said that "fixed" capital might be sunk and lost, and yet the excess of current receipts over current payments might be divided, but that "floating" or "circulating" capital must be kept up, as otherwise it will enter into and form part of such excess, in which case, to divide such excess without deducting the capital which forms part of it, will be contrary to law.

The terms "fixed" and "floating" or "circulating" capital here used are equivalent to that portion of the capital represented by "fixed" or "current" assets.

From the *dicta* of Lindley, L.J., in both the *Neuchatel* and *Verner* cases it is clear that the Court will protect the interests of creditors and that even in a case where it may not be necessary to make good depreciation on wasting assets before paying a dividend sufficient assets must be retained to pay the company's debts and liabilities.

In *Wilmer* v. *McNamara & Co., Ltd.* (*supra*), the Court followed the *Neuchatel* case, Stirling, J., stating that depreciation of goodwill and leaseholds was in his opinion to be treated as a loss of "fixed" capital, and accordingly it was not obligatory on the company to provide for such loss out of revenue before paying any dividend. Some doubt, however, was expressed by him with reference to the adequacy of the provision made for the depreciation of the leaseholds, and it would seem prudent to regard such provision as necessary in ordinary cases.

As already indicated, doubt was thrown upon this series of decisions by the remarks of the Law Lords in *Dovey* v. *Cory* (*supra*). The Court of Appeal in the *National Bank of Wales* case had implied by their judgment that the payment of dividends without making provision for bad debts was not equivalent to paying dividends out of capital, and although the House of Lords was not required to express an opinion on this point, the Lord Chancellor stated the only reason why he referred to it at all was lest by silence he should be supposed to adopt a course of reasoning as to which he was not satisfied that it was correct. He doubted whether such a question could ever be treated in the abstract at all, and expressed his opinion that distinction between "fixed" and "floating" capital might be appropriate enough in an abstract treatise but might be quite inappropriate with reference

to a concrete case. His remarks clearly indicate that the House of Lords held their opinion on these matters in suspense, and did not desire it to be thought that they necessarily upheld the opinions expressed by the Court of Appeal in the *Lee* v. *Neuchatel* series of cases.

Since, however, the decisions in these cases have not been challenged or overruled by the House of Lords during the long period which has elapsed since the *obiter dictum* in the *National Bank of Wales* case was pronounced these decisions must now be regarded as representing the established law on the subject.

In *Ammonia Soda Co.* v. *Chamberlain* (*supra*), the Court of Appeal took the view that it was not in all cases necessary to make good a debit balance on the Profit and Loss Account before paying dividends out of current profits, but regard must be had to the way in which such debit balance has been arrived at, the stage of the company's operations, and to all the facts of the case. The circumstances in which the dividend is paid must not be such that no honest and reasonable man of business would think it right to make the distribution. The payment of dividends out of current profits without making good prior losses is not necessarily the payment of dividends out of capital. It is clear, however, that each case must still be considered on its merits, and it is very difficult to lay down any fixed rule.

The decision in *Stapley* v. *Read Bros. Ltd.* followed the *Ammonia Soda Co.* case in determining that dividends might be paid out of current profits, although the debit balance on the Profit and Loss Account had not been made good out of subsequent profits.

Russell, J., held that profits which had been utilised to write off goodwill in the first instance, had not become irrevocably capitalised; that the company

could place a proper valuation upon the existing goodwill and re-debit the account with that value, crediting the Reserve Account and that such reserve could be utilised so far as might be necessary to write off the existing debit balance of Profit and Loss Account or for distribution as profits available for the payment of dividends.

It is apparent, however, that this course would only be permitted where the assets concerned had been previously written off or written down out of divisible profits to a figure below their true value.

In *Bond* v. *Barrow Hæmatite Steel Company* (*supra*), the company had sustained an actual ascertained and realised loss exceeding £200,000, and a further estimated loss exceeding £50,000. Had these losses been written off no dividend could have been paid.

Farwell, J., said that the question was one of very considerable difficulty on the authorities, but in his opinion the result of these authorities was that there was no hard-and-fast rule by which the Court could determine what is capital and what is profit. The loss in this case arose in connection with certain assets which had been acquired in order to enable the company to produce its own ore instead of purchasing ore in the market, and the Court held that such expenditure was equivalent to expenditure on large stocks of ore bought in advance, and as such, any loss arising thereon should be treated as a loss of circulating capital, which ought to be made good before paying a dividend. It is apparent, therefore, that the classification of assets in any particular case as between "fixed" and "current" is a question of fact which will be decided by the Court, having regard to all the circumstances, and to the opinions of experts and business men, and further that the Courts are strongly disinclined to lay down any general rule on the subject.

As regards the question of depreciation on fixed assets similar remarks apply.

Farwell, J., said in the case quoted above, that the *Neuchatel* case was no authority for the proposition that no company owning "wasting" property need ever create a depreciation fund. In his opinion the Court decided nothing more than that some companies with "wasting" assets need have no depreciation fund. It was for the Court to determine in each case on evidence whether the particular company ought or ought not to have such a fund.

In this connection the decision of the Scotch Courts in *Cox* v. *Edinburgh & District Tramways Co.* ("Glasgow Herald," June 17, 1898) may be noted. The company had incurred a heavy loss in converting their system from horse to mechanical traction, and the Court held that such loss need not be made good before the payment of a dividend, on the ground that it might be assumed that the additional expenditure enhanced the value of the undertaking as a whole.

The legal position as regards depreciation may therefore be summarised as follows :—

(1) Depreciation on "current" assets must be made good before the payment of a dividend (*Verner* v. *General and Commercial Investment Trust, Ltd.*; *Bond* v. *Barrow Hœmatite Steel Co.*).

(2) Depreciation on "fixed" or "wasting" assets need not necessarily be made good before the payment of a dividend, though sufficient assets must be retained to pay liabilities (*Lee* v. *Neuchatel Asphalte Co, Ltd.*; *Bolton* v. *The Natal Land Co.*; *Verner* v. *General and Commercial Investment Trust*; *Wilmer* v *McNamara & Co.*); but as to whether such

provision is necessary or not is a question of fact to be determined by the Court, having regard to the circumstances of each particular case and the Memorandum and Articles of the company concerned (*Dovey* v. *Cory; Bond* v. *Barrow Hœmatite Steel Company*).

The auditor should therefore consider each case in practice according to the circumstances, but in all cases where loss of fixed assets has not been written off he should report the fact to the members. Where, by not making such provision, the financial position of the company is likely to be seriously affected, and its creditors prejudiced, he should draw the attention of the directors and the members to this point of view, and recommend that the necessary provision should be made. Where the omission to provide depreciation will only ultimately affect the members when the company is wound up, the matter is more of a domestic nature for the members themselves to decide, and as long as the auditor places them in possession of the facts, he will have absolved himself from any responsibility in connection with the matter.

§ 3.—Capital Profits.

The question as to whether *capital* profits are available for the payment of dividends, and if so, under what circumstances, is a particularly important one, and there have been two cases decided which will now be summarised, and from which it will be possible to draw some general conclusions.

(a) Legal Decisions.

(1) *Lubbock* v. *The British Bank of South America* (1892, 2 Ch. 198).

Held—THAT A PROFIT MADE ON THE SALE OF A PART OF THE UNDERTAKING OF A COMPANY IS AVAILABLE FOR DIVIDEND, IF THE ARTICLES SO PERMIT.

This company, under the name of the English Bank of Rio de Janeiro, had sold to another bank its goodwill and property in Brazil for a sum of £875,000, agreeing, upon the payment of that sum, to discontinue the use of its name, and to adopt a name not indicating a bank doing business in Brazil, and also contracting to refrain from carrying on business in Brazil. Subsequently this restraint was released on payment by the defendant bank of £75,000; and the £205,000 which it was proposed to distribute consisted of the original consideration for the Brazilian business, less the paid-up capital of the company (£500,000), together with the £75,000 referred to above, and sundry other payments, for outgoings and compensations in reference to the sale of the Brazilian Bank.

Chitty, J., held that the £205,000 was plainly profit on capital, and not part of the capital itself, for that sum was the surplus ascertained after the liabilities and capital were placed on one side of the account and the assets on the other. Under the Articles of the company the directors were justified in carrying over the £205,000 to the Profit and Loss Account; and having appropriated to the Reserve Fund so much of the sum as they thought fit, they could distribute the remainder as dividends after an ordinary meeting, called in pursuance of the Articles, had passed the requisite resolution.

(2) *Foster* v. *The New Trinidad Lake Asphalte Company, Ltd.* (1901, 1 Ch. 208).

Held—THAT A REALISED APPRECIATION IN THE VALUE OF A BOOK DEBT TAKEN OVER BY A COMPANY AT ITS FORMATION IS NOT PROFIT AVAILABLE FOR DIVIDEND, UNLESS SUCH SURPLUS REMAINS AFTER A REVALUATION OF THE WHOLE OF THE ASSETS.

This company at its formation had taken over amongst other assets a debt of $100,000, secured by promissory notes. This debt was not then regarded as of any value, but subsequently it was paid in full, together with interest accrued, realising £26,258 16s. As no value was placed on this asset in the company's books, the amount received was treated as a profit, and it was proposed by the directors to regard it as available for dividend, and to distribute it accordingly, without taking into account any decrease in the value of other assets.

Byrne, J., in the course of his judgment *restraining the distribution*, said :—

"It appears to me that the amount in question is *prima facie* capital and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected. . . . I must not, however, be understood as determining that this sum or a portion of it may not properly be brought into Profit and Loss Account or be taken into account in ascertaining the amount available for dividend. That appears to me to depend upon the result of the whole account for the year. It is clear, I think, that an appreciation in total value of capital assets, if duly realised by sale or getting in of some portion of such assets, may in a proper case be treated as available for purposes of dividend. This, I think, is involved in the decision in the case of *Lubbock* v. *British Bank of South America* (1892, 2 Ch. 198), cited with approval by Lord Lindley in *Verner* v. *General and Commercial Investment Trust* (1894, 2 Ch. 239, at page 265), where he says :—'Moreover, when it is said and said truly, that dividends are not to be paid out of capital the word "capital" means the money subscribed pursuant to the Memorandum of Association, or what is represented by that money. Accretions to that capital may be realised and turned into money, which may be divided amongst the shareholders, as was decided in *Lubbock* v. *British Bank of South America*.' If I rightly appreciate the true effect of the decisions, the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits, in proper cases, although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken."

(b) Legal Decisions considered.

From a consideration of the above cases taken in conjunction with one another, it may be said that

capital profits are not available for dividend unless:

(1) The Articles of Association permit such distribution.

(2) The surplus is *realised*; and ✓

(3) Such surplus *remains* after a proper valuation of the *whole* of the assets has been fairly taken.

In the *New Trinidad* case the company were not apparently prepared to revalue the whole of their assets; had they been willing to do so, and had they been able to prove to the satisfaction of the Court that a capital profit was finally shown, there is no doubt but that the Court would have permitted such profit to be distributed in dividend.

Where expenditure of a capital nature has been charged to revenue, a company can subsequently reimburse revenue out of capital; and the same procedure can be followed where an estimated loss on Capital Account has been charged to revenue, but the assets have subsequently appreciated (*Mills* v. *Northern Rly. of Buenos Ayres Co.*, 1870, 5 Ch. 621; *Bishop* v. *Smyrna and Cassaba Rly. Co.* (No. 2), 1895, 2 Ch. 596).

Capital profit arising on a *bonâ fide* revaluation of fixed assets can be utilised to write off a debit balance on the Profit and Loss Account arising in prior periods, thus enabling dividends to be paid out of current profits (*Ammonia Soda Co.* v. *Chamberlain*, 1918, L.J. 87, Ch. 193).

§ 4.—Divisible Profits.

Having regard to the fact that the legal decisions which have been given on the question of divisible profits depend to a very large extent on the circumstances of each particular case, it is somewhat

hazardous to attempt to lay down in general terms any definition of divisible profits. From the auditor's point of view, however, it is desirable that some general rule should be formulated. Subject, therefore, to the qualifications above-mentioned and to the Memorandum and Articles of the company concerned, the divisible profits of a company may be said to be—

(1) The excess of current income over current expenditure after making good depreciation of current assets and retaining sufficient funds to pay liabilities, but without necessarily in all cases taking into account depreciation of fixed assets.

(2) Capital profits may be divisible if they are realised and a surplus remains after making good any capital losses, and if it is within the powers of the company to distribute such capital profits.

(3) Revenue losses must be made good before profits can be distributed, and capital losses must be made good before capital profits can be distributed; but capital losses need not necessarily be made good before revenue profits are distributed.

It is not, however, necessarily illegal for dividends to be paid out of current profits without making good existing deficiencies in paid-up capital, or without writing off a debit on the company's Profit and Loss Account occasioned by loss in previous years.

§ 5.—Dividends.

The divisible profits of a company having been considered, there remain a number of points which require to be dealt with in connection with the declaration and payment of dividends.

(a) Interim Dividends.

Under clause 115 of Table "A," Companies Act, 1948, the directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company, and where this Table applies, or the operation of this clause is not excluded, the directors will have this power. Most companies having Articles of their own empower the directors to pay interim dividends.

The question as to whether a company is justified in paying an interim dividend, and, if so, to what extent, is a most important one, and the advice of the auditor is frequently asked for. In such circumstances, he should suggest that interim accounts be prepared for the purpose of ascertaining what profits have been made. Many companies have half-yearly accounts prepared for this reason. Assuming such accounts have been prepared, and a profit is shown after making all the necessary adjustments and proper provisions for depreciation, bad debts, etc., the question will arise as to what proportion of such profit can be applied in payment of an interim dividend. Certain considerations must be taken into account before it is possible to arrive at a decision as to the rate of dividend to be paid. Where the dividend is in respect of preference shares, the dividends on which are expressed to be payable half-yearly, and there is ample margin of profit, the full half-yearly dividend may be paid; but in the case of ordinary shares, it is advisable that the interim dividend should be declared at a considerably lower rate than the estimated dividend for the whole year. The payment of an interim dividend at a higher rate than the final dividend is not usual in commercial practice, and the declaration of the final dividend at a lower rate than the interim

dividend generally results in a reduction in the market value of the company's shares.

It must be remembered that an interim dividend is only a payment on account of the whole dividend for the year and, consequently, if an interim dividend is declared in respect of profits earned during a portion of the year, and during the remainder of the year a loss is made, resulting in a loss on the whole year, the interim dividend may have been paid out of capital.

The general conditions and prospects of the trade carried on by the company must, therefore, be taken into account in this connection. The financial aspect of the matter also requires consideration. If the liquid position of the company is not strong, and the whole of the funds in hand are required for carrying on the business, it is not advisable to reduce the resources by distributing an interim dividend, but this general principle may be subject to special considerations which will be referred to subsequently.

In the case of a company carrying on business of a regular and stable nature, where the rate of gross profit earned is subject to little, if any, variation, it may be possible to arrive at a sufficiently accurate estimate of the profits without taking stock or preparing completed accounts. The gross profit for the period can be estimated by reference to the turnover at the average percentage earned in previous years; and the actual expenses incurred by the company can be ascertained from the impersonal ledger. After all the necessary allowances have been made for outstandings, provisions, etc., the net profit can be estimated with sufficient accuracy, although in such cases a greater margin for contingencies should be allowed in fixing the rate of dividend than when actual accounts have been prepared.

It is sometimes thought by persons unacquainted with the fundamental principles of accounts, that if there is a considerable cash balance, this fact is in itself sufficient to justify the payment of an interim dividend, and that the preparation of a Receipts and Payments Account is an adequate substitute for an interim Profit and Loss Account. This idea is entirely fallacious, and, if acted upon, might easily result in the dividend being paid out of capital.

The Receipts and Payments Account might include receipts on account of capital or loans, the proceeds of which have not yet been expended, with the result that a large balance remains in hand; or, on the other hand, considerable capital payments might have been made with the result that the balance in hand might be less, rather than more, than the actual profit earned.

No account is taken of fluctuation in the amounts of stock, debtors or creditors. Stock and debtors might be materially less than at the commencement of the period, and, consequently, the cash balance might be increased, or the creditors might be greater, with a similar result; in neither case might any profit have been earned. No account is taken of the provisions necessary for bad debts, depreciation, or other losses which may not have arisen through cash transactions. Consequently, it is quite conceivable that there might be a large cash balance, when, as a matter of fact, a loss has been sustained, or a small cash balance, when a considerable profit has been earned; and, therefore, no reliance can be placed upon a Receipts and Payments Account, for the purpose of determining whether or not an interim dividend should be paid.

Where a bonus was improperly declared on the faith of a surplus shown by a Receipts and Payments

Account, without the preparation of a Profit and Loss Account and Balance Sheet, and without making due allowance for outstandings, the Court ordered a director who had participated in the bonus to refund the amount received by him (*Rance's Case*, 1871, L.R. 6 Ch. 104).

(b) Final Dividends.

The Articles usually give power for the directors to declare and pay final dividends on preference shares, but not on ordinary shares, a resolution of the members in general meeting being required to authorise the latter.

In no case should a final dividend be declared until the accounts of the year have been prepared and the actual divisible profits ascertained. The considerations which will guide the directors in recommending to the members the amount of the final dividend are similar to those discussed above; and it has already been pointed out that in most cases no dividends can be declared unless previously recommended by the directors, and that they usually have absolute discretion as to the amount they consider it advisable should be distributed, having regard to the actual profits earned by the company, and to their power (if any) to place to reserve any amount they may think necessary before recommending the payment of a dividend. In *Bond* v. *Barrow Hæmatite Steel Co.* (1902, 1 Ch. 358), Farwell, J., said that the Court would be very reluctant to compel directors to divide more than they thought proper; and the Courts will not compel a division of profits up to the hilt, as they regard it as perfectly proper and lawful for a company to carry forward a portion of the year's profits to the credit of next year's Profit and Loss Account (*Burland* v. *Earle*, 1902, A.C. 95).

When once a dividend has been declared and becomes payable it is a debt, and each shareholder is entitled to sue the company for his proportion (*Severn & Wye Railway Co.*, 1896, 1 Ch. 559); but until the dividend has actually been declared, the right to sue does not arise (*Bond* v. *Barrow Hœmatite Steel Co.*, 1902, 1 Ch. 358).

Dividends *declared* but not paid at the date of the Balance Sheet must, therefore, appear as liabilities.

The declaration of an interim dividend, however, will not of itself necessarily create a debt, and the resolution may be rescinded (*Lagunas Nitrate Co.* v. *Schrœder*, 1901, 85 L.T. 22).

Clause 118 of the present Table "A" provides that subject to the rights of persons, if any, entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts *paid* on the shares.

(c) Preference Dividends.

The rights of preference shareholders to dividends will be defined in the Articles, and the question as to whether such shareholders are entitled to simple or cumulative dividends in the absence of express provisions has been considered in Chapter VII, § 2.

Where the dividends on the preference shares depend on the profits of each particular year only, the preference shareholders are entitled to their dividend out of the profits of any year after providing a proper amount for depreciation, maintenance, and renewals for that year, and must not be deprived of their dividend for the purpose of enabling the company to make good amounts which in previous years should have been provided for maintenance, but which have been improperly applied in payment of dividends

(*Dent* v. *London Tramways Co.*, 1881, 16 Ch. 344). A company may not manipulate its accounts for the benefit of any particular class of shareholders, but preference shareholders are not entitled to prevent the company from applying the current profits of any year to making good losses incurred in previous years, or from making such reserves as the directors think necessary under powers conferred on them by the Articles (*Bond* v. *Barrow Hœmatite Steel Co.*, 1902, 1 Ch. 358).

Another case, which is closely analogous to the above, further illustrates this point:—

A railway company had issued certain debentures, the interest on which was payable only out of the net earnings of the company after payment of all working and administration expenses, and such interest was payable only so far as such net earnings, after the payment of such expenses, should extend.

For the year in question, the company made a profit, after payment of interest on prior lien debenture stock, of £19,247, which, added to the sum of £22,250 brought forward from the preceding year, left a balance of £41,497, of which it was proposed to place £10,000 to reserve, and to carry forward the balance of £31,497, without paying any interest to the debenture holders above referred to.

Eve, J., *held* that the amount of £10,000 placed to reserve should be treated as drawn proportionately from the current profits and from the previous year's balance carried forward. This treatment would reduce the current year's profit to about £14,000, and on this he made an order declaring that the company was entitled to set aside so much as in the opinion of the directors was required for the maintenance of the

security, and that the balance ought to be distributed amongst the debenture stockholders (*Heslop* v. *Paraguay Central Railway Company, Ltd.*, 1910, 54 S.J. 234).

(d) Arrears of Cumulative Preference Dividends.

Where the Articles of a company provide that no dividend shall be paid until recommended by the directors, and the directors have power to put to reserve before payment of any dividend, arrears of cumulative preference dividend do not become a liability until a resolution has been passed by the directors to pay them. The liability in respect of such arrears depends not only on the fact of the company earning profits, but also on the resolution of the directors to pay the arrears, which is optional on their part. The fact that the liability is contingent upon an act which the directors may or may not perform at their discretion has the effect of preventing such arrears being regarded as a contingent liability at all, since that phrase implies a liability which will accrue on the happening of some event not within the control of the company or the directors. This view is supported by the case of *Crichtons Oil Co.* (1901, 2 Ch. 184; 1902, 2 Ch. 86); where the rights of the preference shareholders did not arise until a dividend had been declared, and the directors had omitted to declare a dividend before the company went into liquidation, although there were profits which would have been available for the payment of such dividend, with the result that it was held that the preference shareholders were not entitled to their arrears of dividend, the whole of the surplus in that case going to the ordinary shareholders.

If, however, the declaration of the preference dividend is not within the discretion of the directors, but it automatically becomes payable as soon as sufficient profits are earned, any arrears of cumulative preference dividend would be a contingent liability; but a provision of this sort is very uncommon, most Articles providing that no dividend shall be payable until it has been recommended by the directors.

Although such arrears are, in most cases, not a contingent liability, there must be shown as a note or in a statement or report annexed to the accounts the amount of such arrears, before deduction of income tax, and the period for which the dividends or, if there is more than one class, each class of them are in arrears. When the dividends are payable free of income tax, the free of tax amount of the arrears will be shown, and this fact stated (Eighth Schedule, paragraph 11 (3) Companies Act, 1948).

(e) Dividends Paid out of Capital.

Dividends must only be paid out of profits and cannot be paid out of capital, and if the Memorandum or Articles of Association give power to the company to do so, such power is invalid (*Verner* v. *General & Commercial Investment Trust, Ltd.*, 1894, 2 Ch. 264; *re Sharpe*, 1892, 1 Ch. 154).

Where it is alleged that a dividend has been paid out of capital, the onus is on the plaintiff to prove that the dividend comes out of capital.

Directors who knowingly pay dividends out of capital are personally liable to make good the amount of such dividends to the company (*Oxford Benefit*

Building Society, 1887, 35 Ch. D. 502; *re London & General Bank*, 1895, 2 Ch. 673; *re Kingston Cotton Mill Company*, No. 2, 1896, 1 Ch. 331); but where such payment has been made on the faith of a *bonâ fide* valuation of a company's assets, which subsequently proved to be an over-estimate, the directors were not liable (*Stringer's Case*, 1869, 4 Ch. 475; *Rance's Case*, 1871, 6 Ch. 104); although if the Articles state that dividends are only payable out of realised profits, the directors may be responsible for a dividend paid out of estimated profits (*Oxford Benefit Building Society*, 1887, 35 Ch. D. 502).

Directors are entitled to rely upon reports and valuations of trusted officers of a company, unless there is reasonable ground for suspicion (*Re Kingston Cotton Mill Co.*, No. 2, 1896, 2 Ch. 288; *Dovey* v. *Cory*, 1901, A.C. 477).

If dividends are received by members, knowing that they are paid out of capital, the directors may have a right of indemnity against such members to the extent to which they have respectively received dividends, although they have not such right of indemnity if they represent that the dividend is paid out of profits (*Moxham* v. *Grant*, 1900, 1 Q.B. 88); but the directors will primarily be liable to the company (*Re Alexandra Palace Co.*, 1883, 2 Ch. D. 149; *National Funds Assurance Co.*, 1879, 10 Ch. D. 118). Where an interim dividend has been paid out of capital owing to a *bonâ fide* mistake, and the directors propose to recoup such dividend out of profits before distributing any further dividends, a member who has received such dividend cannot maintain an action against the directors (*Towers* v. *African Tug Co.*, 1904, 1 Ch. 158);

and when dividends improperly paid out of capital have been made good out of subsequent profits, liability ceases to attach to the directors (*Boaler* v. *The Watchmakers' Alliance, and others*, 1903, Acct. L.R. 23).

The liability of the auditor in connection with the payment of dividends out of capital is fully dealt with in Chapter X.

(f) Scrip Dividends.

Power is sometimes taken to pay dividends in kind, *i.e.*, by the distribution of specific assets, but unless there is such power, dividends must be paid in cash (*Wood* v. *Odessa Water Works Co.*, 1889, 42 Ch. D. 645; *Hoole* v. *Great Western Railway Company*, 1868, 3 Ch. 262).

Power is frequently taken by finance companies and others, to pay dividends by the distribution of shares or debentures in other companies, and such a distribution is known as scrip dividend. The shares, etc., should be distributed to the members of the company in the same proportion as they are entitled to cash dividends. The distribution must be made free of income tax, and would thus represent to the shareholders a dividend of such an amount as, after deduction of income tax at the standard rate, would leave a net sum equal to the value of the scrip distributed. Power to pay scrip dividends is given by clause 120 of Table "A."

The process of capitalising reserves by the distribution of a dividend or bonus, to be satisfied by the issue of fully-paid shares, or to be applied in reduction of uncalled liability on shares already issued, has been dealt with in Chapter VII, § 15.

(g) Vouching Dividends.

The auditor should vouch the payment of dividends by examining the returned dividend warrants. Usually a separate dividend pass book is utilised, and where this is the case, the checking of the dividend will be materially facilitated. The total dividend paid should be checked at the appropriate rate with the number of shares relating thereto, and the total shares compared with the total of the balances extracted from the Share Ledger. Where the dividend is paid less income tax, it should be seen that the proper rate and amount of tax has been deducted.

Where scrip dividends are issued, a schedule should be submitted to the auditor, showing the shares allotted or transferred to each member, which he should check with the receipts obtained from the members. Where no such receipts have been obtained, reference should be made to the secretary of the company whose shares have been distributed for verification of the schedule.

(h) Unclaimed Dividends.

Dividends are sometimes unclaimed, and where this is so, the amount should be shewn as a liability. If a separate banking account is utilised for the payment of dividends, the unclaimed dividends will appear as a balance on this account as against the corresponding liability.

Dividends constitute a *specialty* debt and as such do not become statute barred for twelve years (prior to the passing of the Limitation Act, 1939, twenty years).

Power may be taken in the Articles to forfeit unclaimed dividends within a shorter period but this is unusual, since the London Stock Exchange will not

grant an official quotation of the shares where the company has this power.

(i) Provision of Moneys for the Payment of Dividends.

Although substantial profits may have been made and dividends may be properly payable, the cash position of the company may make the payment of the dividend a matter of some difficulty. Such a situation may arise owing to a variety of causes. The company's profits may be locked up in book debts or stock, which will be realised in due course, but which have not been realised at the date when it is usual to pay the dividend. In such a case, it is usual for an overdraft at the bank to be arranged for the purpose of paying the dividend.

Where, owing to the extension of the company's business, the profits have been utilised as additional working capital, which will be required permanently, it is not desirable to pay a dividend by temporary borrowing, as the necessity of continually renewing the loan will arise, and it is preferable, either that the borrowing should be of a more permanent nature, taking the form of an issue of debentures, or that fresh capital should be issued. In either case the proceeds of the loan or of the issue of shares can be utilised to pay the dividend.

In other cases the shortage of cash may be due to the fact that the company has incurred capital expenditure which has been made out of realised profits. In this case also temporary borrowing is of no advantage, and the money should be obtained in one of the manners above mentioned.

An alternative method would be to capitalise the profits by the distribution of a dividend to be satisfied

by the issue of fully-paid shares as previously described, or to be applied in reduction of uncalled liability on shares already issued.

From the auditor's point of view no exception can be taken to any of the above methods where the circumstances justify such a course, and the auditor is satisfied that the profits have been actually earned. At the same time, except where the shortage is manifestly due to capital expenditure having been made out of the cash represented by revenue profits, the fact that profits do not appear to be realised should place the auditor upon his guard, and cause him to inquire very carefully into the position. It is apparent that such a situation would be brought about by an improper inflation of stock values, by the omission to make necessary provision for depreciation, bad debts, etc., or by the omission to bring into account outstanding liabilities.

The auditor should satisfy himself, therefore, that none of these factors has operated to bring about the reduction in the cash position, and that the profits are genuine, before passing the adoption of any of the methods described above for the purpose of raising funds for the payment of dividends.

(j) Reserves for the Equalisation of Dividends.

Where the profits of a company fluctuate considerably from year to year, it is sometimes found desirable to institute a reserve for the equalisation of dividends, profits being transferred to the credit of this account in good years, and being withdrawn subsequently when the current year's profits are insufficient to pay the average rate of dividend desired.

If the circumstances of the company are such that the amounts so placed to the credit of the Equalisation Reserve are liable to become locked up in the general assets of the company, and thus are not readily available for the payment of cash dividends when required, it may be desirable that the amounts placed to the credit of the Equalisation Reserve Account should be represented by specific investments, which can then be realised as occasion arises.

Equalisation reserves will be shown in the Balance Sheet as revenue reserves.

CHAPTER IX

THE FORM OF ACCOUNTS

§ 1.—The Form of Final Accounts.

Although it is not the duty of the auditor to draft the accounts, he must see that the form in which they are presented is such as to exhibit a true and fair view of the state of the affairs of the undertaking, and, in the case of companies, that the accounts disclose all the information which is required by Statute to be given therein. Certain Parliamentary companies are obliged by law to present their accounts in prescribed form, and the auditor must see that the relevant requirements have been complied with. In other cases, any adequate form may be employed, so long as the statutory information is given.

The final accounts of a concern will normally comprise a Profit and Loss (or Income and Expenditure) Account and a Balance Sheet.

§ 2.—The Profit and Loss Account.

This is an account to which, at the close of an accounting period, the balances of all the nominal ledger accounts of a revenue character are transferred, in order to ascertain the net profit or loss resulting from carrying on the business during the period.

In the case of concerns such as property holding and investment businesses, whose functions do not comprise the dealing in goods, the account is frequently called the *Revenue Account*, whilst the term *Income and Expenditure Account* is used by non-trading concerns, such as clubs, charities and institutions

which are not carried on with a view to the acquisition of profit.

By whatever name the account is called, its object is to disclose the net profit or loss, or the difference between the total amount of the current income and the current expenditure of a revenue nature, for the period covered by the account.

In the case of businesses whose functions include the manufacture of goods, it is customary to divide the account into several sections, in order that the maximum information with regard to the various stages of the operations may be presented in clear and logical form.

The first section, termed the *Manufacturing* or *Production Account*, is designed to show not only the manufacturing cost of the goods produced during the period, but also the various items of expenditure contributing thereto. The account is accordingly debited with the cost of raw materials and stores consumed, labour and other direct and indirect expenditure incurred in the process of manufacture, and, after making suitable adjustments for the difference between the value of the opening and closing work in progress, the cost of the finished articles produced during the period is revealed. This cost is credited to the Manufacturing Account and debited to the second section, the *Trading Account*. In some cases, however, the transfer from Manufacturing Account to Trading Account is made either at a fixed percentage above cost, or at the estimated market value of the goods produced, in which event the profit or loss on manufacturing operations (as distinct from trading) so revealed is transferred to the Profit and Loss Account.

In many cases the Manufacturing Account is dispensed with (in fact, where the business is purely *merchanting* a Manufacturing Account is entirely inappropriate), a Trading Account only being prepared. If this method is adopted, the Trading Account shows on the debit side the opening stock of raw materials, finished goods and work-in-progress, the purchases, the wages relating to manufacture, and any other expenses of production, such as fuel, inward carriage, etc. On the credit side appear the sales and closing stock and work-in-progress, and the balance then represents the gross profit on trading or manufacturing.

The balance of the Trading Account is carried to the Profit and Loss Account, which is debited with all expenses of distribution and administration of the business. All items of expenditure chargeable against the profits should be included, such as debenture interest, interest on loans, directors' fees, etc., though it is sometimes convenient to ascertain and carry down to a separate section of the account a balance representing the trading profit, before charging these items. In partnership accounts it is very usual for interest on partners' Capital and Current Accounts and partners' salaries to be shown separately from other profit and loss items. The Profit and Loss Account is credited in addition to the gross profit brought down from the Trading Account with all the income of the business which has not been included in the Trading Account, such as cash discount received, income from investments, commissions, etc.

If the various classes of expenditure are grouped together under convenient headings, the utilisation of a column showing the percentage of each group of

expenses to the turnover, or to total expenses, affords valuable information and, if the accounts are kept on a uniform basis, a comparision of these percentages with those of previous periods is of great advantage.

The last section of the Profit and Loss Account, *viz.*, the *Appropriation Account*, shows the balance of profit or loss brought forward from the previous period and the net profit or loss for the current period. All appropriations of profits, such as income tax, transfers to partners' Current Accounts, or dividends paid or recommended in the case of a company, are debited. The balance, in the case of companies, represents the balance of undistributed profit or the accumulated loss, and is shown in the Balance Sheet.

In the case of a sole trader or a partnership, the accounts are not prepared for publication and the Profit and Loss Account is usually drawn up in such detail as will provide the proprietors with the maximum information.

The auditor is very often asked to prepare, in his capacity as accountant, the Balance Sheet and Profit and Loss Account of an undertaking. In doing this, he should bear in mind that these accounts should afford his client as much information as possible, and he must take into consideration the ability of his client to understand formal accounts.

For this reason it is sometimes advisable to prepare the Profit and Loss Account in the form of a statement, rather than a Ledger Account.

The following is a condensed form of a Profit and Loss Statement of this nature suitable for a sole trader :—

SALES, *less* RETURNS		
Deduct—		
Cost of Manufacturing :		
Wages		
Materials		
General Manufacturing Expenses ..		
GROSS PROFIT		
OTHER INCOME		
Deduct—		
Expenses (detailed)		
Deduct—		
Interest on Loans		
Other fixed Charges		
NET PROFIT FOR THE YEAR		
EXCEPTIONAL PROFITS		
Deduct—		
Exceptional charges not applicable to the operations of the year		
TOTAL PROFIT FOR YEAR		

Although the auditor is not responsible for the form of the Profit and Loss Account, he is bound, in the case of companies, to satisfy himself that the account contains all the information required by the Companies Act, 1948, to be given therein, as in his report to the members he must state whether such account :

(*a*) gives the information required by the Act in the manner so required ;

(*b*) is in agreement with the books of account and returns ; and

(*c*) gives a true and fair view of the profit or loss for the financial year.

The requirements of the Act have been dealt with in detail in Chapter VII, § 10 (*b*).

The majority of companies still present the Profit and Loss Account in the conventional ledger account

form, but an increasing number prepare the account in the form of a financial statement referred to *supra*, as this is considered to be more intelligible to shareholders unversed in the science of accounting. It will be appreciated that the published Profit and Loss Account of a public company cannot disclose the detailed information given in the accounts prepared for the use of the directors, but the maximum possible information to shareholders should be furnished thereby, and the Companies Act, 1948, does ensure that the minimum essential information is given.

A typical published Profit and Loss Account set out in this form is given below.

			£	*19—* £
Trading Profit, after deducting all working costs but before charging directors' remuneration and depreciation			156,200	*171,250*
Deduct ;				
Directors remuneration :				
Fees	£1,000			*1,000*
Emoluments ..	15,000			*13,000*
Pensions ..	1,000			*500*
		17,000		
Depreciation ..		28,500		*29,000*
Debenture Interest				*1,000*
			45,500	*44,500*
			110,700	*126,750*
Dividends and Interest Receivable :				
Subsidiary companies		18,100		*15,000*
Trade investments		6,450		*7,000*
Other investments		5,100		*5,000*
			29,650	
c/f			£140,350	*153,750*

			19—
		£	£
	b/f	140,350	*153,750*
Exceptional Profits :			
Profit on sale of raw materials no longer required		8,000	—
Net Profit for year before charging taxation thereon		148,350	*153,750*
Taxation (estimated to be payable on the net profit shown above) :			
Income Tax	70,000		*80,000*
Profits Tax	18,000		*15,000*
		88,000	
Net Profit for year		£60,350	*£58,750*
Appropriations :			
General reserve	10,000		*10,000*
Debenture redemption ..	—		*5,000*
		10,000	
		50,350	*43,750*
Balance brought forward from previous year		21,240	*10,490*
Balance available for distribution		71,590	*54,240*
Dividends paid and proposed on the company's ordinary shares :			
Interim dividend of 10%, less Income Tax	11,000		
Proposed final dividend of of 20%, less Income Tax ..	22,000		
		33,000	*33,000*
Balance carried forward ..		£38,590	*£21,240*

§ 3.—The Balance Sheet.

(a) Definition.

A Balance Sheet is a classified summary of the balances remaining in a set of books, after the Profit and Loss account has been prepared, and including the balance of that account. It contains, on the one side, a classified statement of the book value of the

assets as at a particular date, and on the other, the amount and extent of the interest of the proprietors and creditors in such assets. Except in the case of current assets whose market value at the date of the balance sheet is less than their cost, it does not profess to disclose either the realisable or the "going concern" value of the assets. What it does show is the capital employed in the business and the various sources from which such capital is derived, and, under appropriate headings, the expenditure incurred in the acquisition of assets used in the business to the extent that it has not been used up or written off. In other words, a Balance Sheet is little more than a statement of unexpired or unexhausted expenditure. Although a Balance Sheet may afford useful information as to the nature of the security underlying the share capital, as to the adequacy or otherwise of the liquid resources, and as to the general financial stability of the concern, it gives no indication of its income-earning capacity, which is the principal factor to be considered in estimating the proprietorship worth of a business.

(b) Form.

In a Balance Sheet the assets and liabilities should be properly grouped and arranged in logical order. Separate sub-headings and sub-totals should be shown of the various groups of assets and liabilities, and all reserves and other balances representing undistributed profits should be aggregated with the issued share capital to show in one total the interest of the proprietors in the assets of the company. The Companies Act, 1948, lays down certain rules as to the information to be afforded by the Balance Sheets of companies as well as to the manner in which they are to be grouped. This question has been fully dealt with in Chapter VII.

In the majority of cases, Balance Sheets of companies are presented to show assets on the right hand side and capital, liabilities and reserves, etc. on the left hand side. As in the case of the Profit and Loss Account, however, many companies present their Balance Sheets in the form of a statement which perhaps reveals to a layman more clearly the manner in which the company's capital has been invested. The following is an illustration of a Balance Sheet in this form.

FIXED ASSETS—		£
Land and Buildings at cost		300,000
Plant and Machinery at cost	£200,000	
less depreciation	40,000	
		160,000
Goodwill, Patents, etc., at cost *less* amounts written off		240,000
Total Fixed Assets		700,000
Deduct :		
Debentures carrying a fixed charge on the Land and Buildings, plus accrued interest		15,600
Fixed Assets, *less* specific charges		684,400
	£	
CURRENT ASSETS—		
Stock-in-Trade	22,500	
Work-in-Progress	10,900	
Sundry Debtors	18,100	
Bills Receivable	2,900	
Cash at Bank	6,200	
Cash in hand	300	
	60,900	
Deduct :		
Sundry Creditors	8,900	
Working Capital		52,000
Excess of assets over liabilities and specific provisions		736,400
Deduct :		
Debentures secured by a floating charge on the assets of the company		30,000
		£706,400
Representing Capital and Undistributed Profits :—		
Authorised and Issued Share Capital :		£
300,000 5% Preference Shares of £1 each		300,000
200,000 Ordinary Shares of £1 each		200,000
General Reserve		150,000
Profit and Loss Account		56,400
		£706,400

§ 4.—Group Accounts.

Where at the end of its financial year a company has subsidiaries it must, in addition to its own accounts, lay before its members accounts or statements, called *group accounts*, which show the combined position of the company and such subsidiaries both as regards assets and liabilities and profit or loss (Section 150, Companies Act, 1948).

A company is a subsidiary of another company if, but only if—

(*a*) the other company is either—

(i) a member of it and controls the composition of its board of directors; or

(ii) holds more than half in nominal value of its equity share capital; or

(*b*) the company is a subsidiary of any company which is the other company's subsidiary.

A company is deemed to control the composition of the board of directors of another company if it can, by the exercise of some power exercisable by it without the consent or concurrence of any other person, appoint or remove the holders of all or a majority of the directorships. The company of which another company is deemed to be a subsidiary is known as the *holding* company.

The obligation to lay group accounts before the members of the holding companies does not apply where the company is, at the end of its financial year, the wholly-owned subsidiary of a body corporate incorporated in Great Britain; moreover, group accounts need not deal with a subsidiary if the directors of the holding company are of opinion that—

(i) it is impracticable, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company ; or

(ii) the result would be misleading, or harmful to the business of the company or any of its subsidiaries ; or

(iii) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

If the directors are of such an opinion about each of the company's subsidiaries, group accounts are not required.

The approval of the Board of Trade is required for not dealing in group accounts with a subsidiary on the ground that the result would be harmful, or on the ground of the difference between the business of the holding company and that of the subsidiary (Section 150).

For the above purposes a company is deemed to be the wholly-owned subsidiary of another if it has no members except that other and that other's wholly-owned subsidiaries and its or their nominees.

(a) The Form and Contents of Group Accounts.

Section 151, Companies Act, 1948, provides for the form of group accounts as under :—

(1) Subject to the next following subsection, the group accounts laid before a holding company shall be consolidated accounts comprising—

(*a*) a consolidated Balance Sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts ;

(*b*) a consolidated Profit and Loss Account dealing with the profit or loss of the company and those subsidiaries.

(2) If the company's directors are of opinion that it is better for the purpose—

(*a*) of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries ; and

(*b*) of so presenting it that it may be readily appreciated by the company's members ;

the group accounts may be prepared in a form other than that required by the foregoing subsection, and in particular may consist of more than one set of consolidated accounts dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

(3) The group accounts may be wholly or partly incorporated in the company's own Balance Sheet and Profit and Loss Account.

The group accounts must give a true and fair view of the state of the affairs and profit or loss of the holding company and its subsidiaries as a whole, so far as concerns members of the company and comply with the following requirements of the Eighth Schedule to the Companies Act, 1948.

(*a*) The group accounts must combine the information contained in the separate Balance Sheets and Profit and Loss Accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts, but with such adjustments (if any) as the directors of the holding company think necessary.

(*b*) The consolidated accounts must, so far as is practicable, comply with the requirements of the Act as if they were the accounts of an actual company.

It is not, however, necessary to show in the consolidated accounts the information required by

Sections 196 and 197 to be disclosed regarding directors' remuneration and loans to officers of the company. This information must be given in the separate accounts of the companies concerned. Section 196 (5) provides that the information to be given in regard to directors' emoluments, pensions and compensation for loss of office shall include all relevant sums paid by or receivable from—

(i) the company; and

(ii) the company's subsidiaries; and

(iii) *any other person.*

In the opinion of counsel obtained by the Institute of Chartered Accountants the expression "any other person" includes any body corporate, *e.g.*, for the purpose of a subsidiary company's accounts, its holding company or any other company in the group or outside it. Accordingly, if a director of a holding company is also a director of a subsidiary and the whole of his emoluments are paid and borne by the holding company (such emoluments including emoluments paid to or receivable by him in respect of his services as director of the subsidiary), the whole of the sums received by the director from the holding company must, unless apportioned, be shown in a statement annexed to the subsidiary's accounts. If, for instance, a director is paid £1,000 by a holding company for services as a director of the holding company and four subsidiaries, and the sum is not apportioned by the directors of the holding company, then the holding company and each subsidiary would be bound to show this sum, either in the accounts or in a statement annexed thereto. Counsel further stated that in their opinion, provided that the directors of the subsidiary

are not mere figureheads accepting the instructions of the holding company without regard to their duties as directors of the subsidiary, it could not be said that the holding company is a director of the subsidiary.

Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts must, unless the Board of Trade on the application or with the consent of the holding company's directors otherwise direct, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year (Section 152 (2)). It is the duty of the holding company's directors, however, to arrange for the financial year of each subsidiary to coincide with the financial year of the holding company, unless in their opinion there are good reasons against such a procedure.

The opinion of counsel obtained by the Institute of Chartered Accountants on this matter is given below.

"In our opinion the accounts of a subsidiary dealt with in consolidated accounts need not have been formally adopted by the subsidiary in general meeting. But unless the Board of Trade, on the application or with the consent of the holding company's directors, otherwise directs, the group accounts must deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year. If the Board of Trade makes a direction that the group accounts need not, as regards a particular subsidiary, comply with Section 152 (2) then in our opinion special accounts of the subsidiary would have to be made up to the date authorised by the direction."

It will be observed that the directors of the holding company may, if they have good reasons for doing so, continue to allow the financial year of a subsidiary to end on a date other than the closing date for the accounts of the holding company: The directors also

have power to exclude a subsidiary from the group accounts, and if they think that all subsidiaries should be excluded, then they may decide not to prepare group accounts. The Institute of Chartered Accountants obtained the opinion of counsel on these powers of the directors and the opinion obtained is given hereunder.

"In our view the responsibility for giving the opinion that group accounts need not deal with a particular subsidiary or that there are good reasons against the financial year of any of the subsidiaries of a holding company coinciding with the holding company's own financial year is that of the directors of the holding company alone. If in giving their opinion the directors make statements of fact which are inconsistent with the accounts, the auditors will be bound to draw attention to this in their report. Where, however, the reasons given by the directors are matters of opinion, or matters of fact which are consistent with the accounts on which the auditors are reporting, the auditors in our opinion owe no duty to the shareholders to make any comment on the directors reasons."

As indicated in Chapter VII where group accounts are not submitted, the reason therefor must be given in a statement annexed to the balance sheet. This statement must also show—

(i) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiaries' profits after deducting the subsidiaries' losses (or *vice versa*)—

(*a*) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(*b*) for their previous financial years since they respectively became the holding company's subsidiary;

(ii) the net aggregate amount of the subsidiaries' profits after deducting the subsidiaries' losses (or *vice versa*)—

(*a*) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(*b*) for their other financial years since they respectively became the holding company's subsidiary;

in-so-far as those profits are dealt with, or provision is made for those losses, in the company's accounts.

The purpose of the above provisions is to ensure that where group accounts are not prepared, shareholders should be given information regarding their share of annual and accumulated profits, including revenue reserves, or losses of the group as a whole, equivalent to that which they would have been given in consolidated accounts. The information which would thereby have been provided regarding the profits, less losses of subsidiaries, would have included the following :—

(*a*) the amount thereof which has neither been dealt with in the holding company's accounts of the year nor in its accounts of any prior year, and

(*b*) the amount of profits, less losses, dealt with in the holding company's accounts of the year subdivided to distinguish the amounts derived respectively from current and other results of the subsidiaries dealt with.

The wording of the provisions is, however, far from clear because, in law, the references to "accounts" of the holding company mean only the accounts of the year. Taken literally, therefore, the provisions call for the disclosure of figures of profits, less losses, of

subsidiaries for the whole period from the dates of the acquisition of the shares therein, less only the amounts dealt with in the holding company's accounts of the year and nòt after deducting amounts dealt with in earlier accounts of the holding company. This interpretation would result in much useless information being given to shareholders. In view of this the Council of the Institute of Chartered Accountants invited the Board of Trade to clarify the position and were authorised to state that the Board of Trade would take no exception to the requisite information being given on the lines indicated in (*a*) and (*b*) above. The form of statement on these lines would be as under:

	Profits in respect of financial years of subsidiaries		
	Ending in 1950	*Other years*	*Total*
The aggregate amount of the profits less losses(†) of the subsidiaries so far as it concerns the members of the company(‡)—			
(i) dealt with in this company's accounts for the year 1950 amounted (gross) to ..	£10,072	—	10,072
Less: Income Tax	4,532	—	4,532
	£5,540	§	5,540
(ii) not dealt with in this company's accounts for the year 1950, amounted, after charging taxation, to	£15,000	10,000	25,000

† Where applicable.

‡ Where one or more than one subsidiary is not wholly owned.

§ "Other years" will normally be years of subsidiaries ending prior to the holding company's year 1950; but if an interim dividend were declared by a subsidiary out of its profits for a year ending within the holding company's year 1951 and taken up in the holding company's accounts for 1950, the amount of such interim dividend would be included in this column.

(b) The Audit of Group Accounts.

In the accounts of the holding company the shares held in and indebtedness to and by subsidiaries must be shown separately, and in order that he may report that the balance sheet shows a true and fair view of the affairs of the company, the auditor must take whatever steps may be necessary to satisfy himself as to the values placed upon these items. In this respect his duty differs in no way from that in relation to other assets and liabilities of the holding company.

For the purpose of such verification the auditor should examine the last Balance Sheets and accounts of the subsidiary companies in order to form an opinion whether or not the shares held therein are worth the values placed upon them in the holding company's Balance Sheet. If it is found that any of the subsidiary companies have suffered losses, this would probably have the effect of depreciating the value of the shares, and if such depreciation has not been provided for in the accounts of the holding company, the auditor should refer to this fact in his report.

The Balance Sheets and Profits and Loss Accounts of the subsidiaries should also be consulted by the auditor of the holding company, to enable him to verify to what extent the profits or losses of the subsidiary companies have been incorporated in the holding company's accounts. Furthermore, where a subsidiary company is indebted to its holding company, an examination of the Balance Sheet and accounts of that subsidiary by the auditor of the holding company is necessary to ascertain whether that subsidiary is apparently solvent, and whether or not some provision for possible loss in connection with the

indebtedness of the subsidiary should be made by the holding company.

Where group accounts are prepared, the auditor of the holding company submitting such accounts must in his report state whether, in his opinion, the group accounts have been properly prepared in accordance with the Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries so far as concerns members of the company. Where such accounts are submitted in the form of consolidated accounts, the auditor's report should deal therewith in the following terms :—

"I have also examined the annexed consolidated Balance Sheet and consolidated Profit and Loss Account of the company and its subsidiaries dealt with thereby with the audited accounts of those companies *certain of which have not been audited by me. Subject to the foregoing*, in my opinion such consolidated Balance Sheet and consolidated Profit and Loss Account have been prepared in accordance with the provisions of the Companies Act, 1948, so as to give a true and fair view respectively of the state of affairs and of the profit (or loss) of X Ltd., and its subsidiaries dealt with thereby, *and so far as is practicable having regard to the fact that accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X Ltd.*"

The words given in italics will be included only where appropriate.

Where group accounts other than consolidated accounts are submitted, the auditor of the holding company should deal therewith in his report in the following terms :—

"I have also examined the annexed group accounts, comprising . . . ., with the audited accounts of the companies dealt with thereby, *certain of which have not been audited by me. Subject to the foregoing*, in my opinion the group accounts have been properly prepared in accordance with the provisions of the *Companies Act*, 1948, so as to give, *in conjunction with the Balance Sheet and Profit and Loss Account of X Ltd.*, a true and fair view of the state of affairs and of the profit (or loss) of X Ltd., and its subsidiaries dealt with by such group accounts, so far as

concerns members of X Ltd., *and so far as is practicable having regard to the fact that accounts of some of the subsidiaries are made up to different dates and cover different periods from those of X Ltd.*"

The words in italics will only be included where appropriate. The words "in conjunction with the Balance Sheet and Profit and Loss Account of X Ltd." will be deleted where the holding company's accounts are also incorporated in the group accounts.

In view of the fact that the auditor of a holding company must report on group accounts involving the accounts of companies of which he may not be the auditor, the Institute of Chartered Accountants obtained the opinion of counsel on the responsibility undertaken in this respect by the auditor. The opinion obtained is given hereunder.

"In view of the specific requirements of the Ninth Schedule the holding company's auditors cannot, in our opinion, avoid responsibility as regards the accounts of subsidiaries not audited by them merely by indicating in their report that the information regarding subsidiaries is based upon accounts of subsidiaries not audited by them.

"Nevertheless, whilst the holding company's auditors should take all reasonable steps to satisfy themselves with regard to the accounts of subsidiaries not audited by them, we recommend that for their own protection they should qualify their report in respect of such accounts in the manner indicated in the forms of report approved by us. (*These are the forms given above.*)

"Where group accounts are submitted in the form of separate accounts dealing with each of the subsidiaries, the report of each subsidiary's auditors must, in our opinion, be attached to the subsidiary's accounts, unless the subsidiary's accounts have been adjusted in respect of the interests of minority shareholders or otherwise to give effect to the requirements of the Act."

In the opinion of counsel, Section 162 and the Ninth Schedule to the Companies Act, 1948, contemplate only one report and it would not, therefore, be permissible for the paragraph relating to the group accounts to form a separate report annexed to those accounts.

(c) The Consolidation of Accounts.

In the large majority of cases the group accounts take the form of consolidated accounts, in which the whole group is regarded as one undertaking, and the whole of the assets and liabilities of all the companies in the group are incorporated in one Balance Sheet. Similarly, the income and expenditure of all the companies are combined in one Profit and Loss Account. The members are thus able to form some opinion as to the security underlying their shares. It also makes it possible for them to see what surplus is available for dividend purposes, and how much of the capital of the holding company is represented by payments for goodwill, or the cost of acquiring control of the subsidiaries.

On the other hand, consolidated accounts may be objected to on the ground that they do not show which of the constituent companies are earning profits, and which are making losses. This may be important where the bulk of the profits are earned by a company which has small capital commitments, whereas other companies which have heavy liabilities in the form of debentures, etc., are making losses.

For the purpose of preparing consolidated accounts, regard must be had *inter alia* for the following :—

(i) The Balance Sheets of all the companies must be made up to the same date, or proper adjustments made to enable the exact position at the date of consolidation to be ascertained.

(ii) All assets and liabilities must be classified and valued on similar bases, or proper

adjustments made to bring them on to similar bases.

(iii) A consolidated Balance Sheet is merely the Balance Sheet of the holding company, in which, however, the item "Shares in Subsidiary Companies" is replaced by the actual assets and liabilities of the subsidiary companies, which represent such shares. Where, therefore, the price paid for the shares exceeds the book value of the actual net assets of the subsidiary as at the date of acquisition, such excess represents the price paid for goodwill, and must be shown as such in the consolidated Balance Sheet, the other assets and liabilities being shown under their respective headings.

(iv) If the holding company does not own the *whole* of the capital of the subsidiaries, the consolidated Balance Sheet must show *as a liability* the total interests of all outside shareholders in the subsidiaries.

Alternatively, only the *proportion of each separate asset and liability* which is attributable to the capital in the subsidiary company held by the holding company may be included in the consolidated Balance Sheet, the interest of the outside shareholders being entirely eliminated. This latter method, however, may lead to complications, and is not to be recommended.

(v) In the consolidated Balance Sheet it is usual to credit all reserves and profits of the subsidiary *existing at the time of the acquisition of the controlling interest* to a capital reserve,

and then to transfer therefrom to the liability to outside shareholders the proportion attributable to their holding, carrying the balance to *contra* to be deducted from the excess of the cost of the shares over their nominal value in order to compute goodwill.

(vi) If the shares in the subsidiary were purchased at a discount (*i.e.*, the price paid for the shares was *less* than the net book assets acquired) the discount must be *deducted* from goodwill. (If this results in a credit balance, then, following general accounting principles, there will be a capital reserve.) If there was a deficiency of assets in the subsidiary (*e.g.*, a Profit and Loss Account debit balance) this must be *added* to the cost of goodwill, as the *tangible* assets acquired are reduced by such deficiency.

(vii) Where the shares in the subsidiary were acquired some time prior to the date of the consolidated Balance Sheet, the reserves and Profit and Loss Account balances of the subsidiary will probably include profits earned *since* the acquisition of the shares. Such profits are divisible between the holding company and the outside shareholders—the holding company's proportion being transferred to the consolidated Profit and Loss Account, and the outside shareholders' proportion to the liability to outside shareholders. *Only the reserves and profits in existence at the date of the acquisition are taken to capital reserve, all subsequent profits being properly taken to revenue.*

(viii) If all or any of the preference shares in subsidiary companies are not held by the holding company, the nominal value of the preference shares not so held should be shown as a liability.

(ix) Inter-company indebtedness must be set off, and not included either as an asset or as a liability in the consolidated Balance Sheet.

(x) Inter-company profits included in stocks or other assets, should be deducted from Profit and Loss Account, and from the appropriate assets, so as to reduce these items to their cost *to the combine.* If, however, there are outside shareholders, *only the holding company's proportion of such profit should be eliminated,* since from the point of view of the outside shareholders, the profit *has* been realised, and to the extent that the profit is attributable to the shares held by outside shareholders it increases the cost of the goods to the combine.

(xi) In the consolidated Profit and Loss Account the proportion of the profit or loss attributable to outside shareholders must be deducted and included in the liability to outside shareholders in the consolidated Balance Sheet. Any inter-company dividends, purchases, sales, and expenses shown in the respective Profit and Loss Accounts will form *contra* items in the consolidated Profit and Loss Account, and will be eliminated therefrom.

For the purposes of his report on consolidated accounts the auditor should pay particular attention to the following matters :—

(1) The computation of the amount shown under the heading of goodwill. This will consist of the amounts appearing as goodwill in the respective Balance Sheets plus the excess of the cost of the parent company's holdings in the subsidiary companies over the net assets represented by such holdings at the date of acquisition of the control, or less the excess of the net assets over the cost of the holdings at the same date.

(2) The liability to minority interests in the subsidiary companies. This will be represented by the nominal amount of the shares held by outside shareholders of the subsidiary companies, plus or minus the proportion of the reserves or Profit and Loss Account balances of the subsidiaries as at the date on which the consolidated Balance Sheet is drawn up.

(3) The adjustment of any inter-company liabilities.

(4) The elimination of unrealised inter-company profits.

(5) If any of the assets of the subsidiary companies have been revalued for the purpose of the consolidated Balance Sheet, it should be seen that proper effect has been given to such revaluation in arriving at the amount of the goodwill and the liability to minority interests. It should also be ascertained that the charge to Profit and Loss Account for depreciation, by reference to such revaluation, has been adjusted.

(6) In the consolidated Profit and Loss Account it should be seen that proper adjustment has

been made for dividends paid by the subsidiary company to the parent company. If any dividend has been paid out of profits existing at the date on which the parent company acquired its holding in a subsidiary, such dividend should be deducted from the purchase price of the shares in arriving at the value of goodwill, and should not appear in the consolidated Profit and Loss Account.

(7) Where the accounts which have been consolidated are made up to different dates, the adjustments (if any) which have been made, in order that the financial position and the profit or loss of the group, as shown by the consolidated accounts, shall not be distorted or misrepresented.

Adjustments may be necessary in the following circumstances :—

(*a*) Where a substantial trading loss is known to have been sustained by a subsidiary between the end of its financial year and the date of the consolidated accounts.

(*b*) Where the liquidity of the group has been materially changed by the transfer of cash or other assets from one member of the group to another, or where substantial capital expenditure has been incurred, in the interval between the Balance Sheet dates.

(*c*) For the purpose of reconciling the balances on inter-company accounts in respects of cash and other assets in transit.

(8) The conversion into sterling, for the purpose of the consolidated accounts, of the figures relating to foreign subsidiaries.

CHAPTER X

THE LIABILITY OF AUDITORS

§ 1.—The Liability of Auditors.

An auditor's liability, in relation to accounts which he has audited, may arise from any of the following sources :—

(1) Liability for Negligence under the Common Law.

(2) Liability under Statute.

(*a*) Civil—Companies Act, 1948.

(*b*) Criminal—Companies Act, 1948.
Larceny Act, 1861.
Larceny Act, 1916.
Falsification of Accounts Act, 1875.

§ 2.—Liability for Negligence under the Common Law.

Every agent is presumed to bring reasonable skill and diligence to bear upon the work which he is employed to do, and an auditor, who may be said to be an agent to the extent of his duties as auditor, is no exception to this rule. If, therefore, an auditor is guilty of negligence in the execution of his duty, he may be held liable to make good any damage resulting from that negligence.

This liability springs from the general principle of law that where a person is under a legal duty to take care, whether imposed by specific contract or

otherwise, the failure to exercise a *reasonable standard* of care will make that person responsible for any resultant damage or loss to those to whom the duty is owed. What conduct satisfies the standard of care required will, in any particular case, depend entirely upon the circumstances. In the present state of professional accountancy, the general average of skill and diligence attained by auditors has reached a high standard, and the question as to whether an auditor is or is not guilty of negligence in any particular case, is largely determined by a comparison with the standard to which the average members of the profession conform.

§ 3.—Liability under Statute.

(a) Civil.

(1) *Companies Act*, 1948, *Section* 333.

If in the course of the winding-up of a company it appears that the auditor has been guilty of any misfeasance or breach of trust in relation to the company, he may be held liable, but only where he has acted so as to constitute himself an officer of the company. The Court, on the application of the official receiver, the liquidator, or any creditor or contributory, may examine into his conduct, and compel him to contribute such sum to the assets of the company by way of compensation in respect of the misfeasance or breach of trust as the Court thinks just. Liability under this section can only arise in the case of the winding-up of a company.

It is laid down by Section 448, however, that where in any proceedings for negligence, default, breach of duty, or breach of trust against an auditor, it appears to the Court hearing the case—

(*a*) that he is or may be liable;

(*b*) that he has acted honestly and reasonably;

(*c*) that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for negligence, etc.,

the Court may relieve him wholly or partly on such terms as it may think fit.

Where the auditor has reason to apprehend that any claim will, or might be made against him in respect of any negligence, default, breach of duty or breach of trust, he may apply to the Court for relief without waiting for proceedings to be taken against him. The Court, on such an application, has the same power to relieve him as it would have had if it had been the Court before which proceedings against him for negligence, etc., had been brought.

Relief under this section may be granted to the auditor of a company, whether he is an officer of the company or not.

(b) Criminal.

(1) *Companies Act*, 1948, *Section* 438.

If an auditor in any report, certificate, balance sheet or other document wilfully makes a statement false in any material particular he may be criminally liable under Section 438. The maximum penalty in England or Scotland on summary conviction is imprisonment with or without hard labour for a period of four months, and a fine not exceeding £100 in lieu of or in addition to imprisonment. The reports, certificates, etc., mentioned above are those required by or for the purposes of the Act and are specified in the Fifteenth Schedule.

Conviction under this section will not operate to relieve the auditor from liability for misfeasance under Section 333.

(2) *The Larceny Acts,* 1861 *and* 1916.

Section 20 (2) of the Larceny Act, 1916, provides that any director, member and officer of any body corporate or public company, fraudulently taking or applying for his own use or benefit, or for any use or purposes other than the use or purposes of such body corporate or public company any of the property of such body corporate or public company, shall be guilty of a misdemeanour, and liable on conviction to penal servitude for a term not exceeding seven years.

Section 83 of the Act of 1861 extends similar liability in cases where such persons, with intent to defraud, wilfully destroy, alter, mutilate, or falsify any books, papers, or documents belonging to the company.

It is not likely that an auditor, as such, could come within the operation of the above sections, but Section 84 of the Act of 1861, might involve the auditor in liability where he has acted as an officer of the company. The section provides that:

"Whosoever, being a director, manager, or public officer of any body corporate or public company, shall make, circulate, or publish, or concur in making, circulating, or publishing, any written statement or account which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder, or creditor of such body corporate or public company, or with intent to induce any person to become a shareholder or partner therein, or to entrust or advance any property to such body corporate or public company, or to enter into any security for the benefit thereof, shall be guilty of a misdemeanour, and being convicted thereof shall be liable, at the discretion of the court, to any of the punishments which the court may award as hereinbefore last mentioned."

In the case of *Dumbell's Banking Company, Limited* (1900 Acct. L.R. 181), the prosecution was instituted against the directors and auditors of the

company under the Manx Criminal Code, 1872, Section 221, which is identical with Section 84 of the Larceny Act, 1861, quoted above. The jury found all the defendants guilty, including the auditors, and they were sentenced to varying terms of imprisonment.

Reference may be made also to the *Royal Mail* case dealt with later in this chapter.

(3) *The Falsification of Accounts Act*, 1875.

This Act is required to be read in conjunction with the Larceny Act, 1861, and consists of the following Sections :—

1. That if any clerk, officer, or servant, or any person employed or acting in the capacity of a clerk, officer, or servant, shall wilfully and with intent to defraud, destroy, alter, mutilate, or falsify any book, paper, writing, valuable security, or account which belongs to or is in the possession of his employer, or has been received by him for or on behalf of his employer, or shall wilfully, and with intent to defraud, make, or concur in making, any false entry in, or omit or alter, or concur in omitting or altering, any material particular from, or in any such book, or any document or account, then in every such case the person so offending shall be guilty of a misdemeanour, and be liable to be kept in penal servitude for a term not exceeding seven years, or to be imprisoned with or without hard labour for any term not exceeding two years.

2. It shall be sufficient in any indictment under this Act to allege a general intent to defraud, without naming any particular person to be defrauded.

§ 4.—Legal Decisions.

(a) Leeds Estate Building and Investment Co. *v.* Shepherd. (1887, 36 Ch. D. 787.)

Held—THAT AN AUDITOR WHO IS NEGLIGENT IN THE PERFORMANCE OF HIS DUTIES IS LIABLE FOR DAMAGES.

This company was formed for the purpose of dealing in loans and lending money on mortgage; the remuneration of the directors was payable in proportion to the dividend paid, no dividend being payable except out of profits. No profit was made by the company

during the whole period in which it carried on business, except in one year. The action was brought by the company against the directors, the manager, and the auditors, to make them liable in respect of certain sums paid out of capital for dividend, and the fees and bonuses of directors and manager respectively. The Balance Sheets were false and misleading, and contained fictitious items, being prepared with a view to the declaration of dividends.

The accounts were examined by the auditor, but he was not furnished with a copy of the Articles, and he did not comply with their provisions. The directors were not aware that dividends had been paid out of capital, or that the Balance Sheets were inaccurate.

In the course of his judgment, Stirling, J., said :—

"It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it is a true and accurate representation of the company's affairs. It was no excuse that the auditor had not seen the articles when he knew of their existence. The Statute of Limitations had been pleaded on his behalf, and the plea had not been resisted, so that his liability would be limited to the dividends paid within six years of the commencement of the action."

(b) In re London & General Bank (No. 2). (1895, 2 Ch. 682.)

Held—THAT AN AUDITOR, WHO DOES NOT REPORT TO THE SHAREHOLDERS THE FACTS OF THE CASE WHEN THE BALANCE SHEET IS NOT PROPERLY DRAWN UP, IS GUILTY OF MISFEASANCE.

This case was heard after it had been determined by the Court of Appeal that the auditor of the company was an officer of the company within the meaning of the Companies (Winding-up) Act, 1890 (*in re London & General Bank*, No. 1, 1895, 2 Ch. 166). So far as this point of view is concerned, the case has already been considered in Chapter VI, § 2 (*b*).

This was an appeal by Mr. Theobald, one of the auditors of the London & General Bank, which was being wound up, against an order made by Vaughan Williams, J., under Section 10 of the Companies (Winding-up) Act, 1890 (now Section 333 of the 1948 Act). By this order Mr. Theobald and the directors of the bank were declared jointly and severally liable to pay to the Official Receiver of the company two sums of £5,946 12s. and £8,486 11s., being respectively the amounts of dividends declared and paid by the bank for the years 1890 and 1891, with interest on those sums. The grounds on which this order was made on Mr. Theobald were that these dividends were paid out of capital, and that such payment was made pursuant to resolutions of the shareholders, based upon the recommendation of the directors of the bank, and upon Balance Sheets prepared and certified by Mr. Theobald, which did not fully represent the financial position of the company.

The failure of the company was principally due to the fact that large sums had been advanced to customers on loan and current account, in respect of which the security lodged was entirely insufficient, and the dividends in question were paid out of sums taken to the credit of profit and loss in respect of interest on such advances, which interest was never, as a fact, paid. Had proper provision been made for bad debts in respect of sums advanced, and interest accrued thereon, the accounts of the company would not have shown a profit, but a loss.

The Court held that the auditor was liable to refund, by way of damages, the amount of the second dividend, on the ground that he was aware of the critical position of affairs, and acted negligently in

not reporting the facts to the shareholders, although he reported them to the directors. As regards the first dividend, the Court did not hold the auditor liable, as it was of opinion that the evidence was not sufficiently strong to establish a case of misfeasance against him, although it thought he was guilty of an error of judgment.

In the course of his judgment, Lindley, L.J., said (Acct. L.R. 1895, 173):—

"It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without enquiry, and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the auditor has to frame a balance-sheet showing that position according to the books, and to certify that the balance-sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. An auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance-sheet is accurate according to the books of the company. If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little enquiry will be reasonable and quite sufficient; and in practice, I believe, business men select a few cases haphazard, see that they are right,

and assume that others like them are correct also. When suspicion is aroused, more care is obviously necessary; but still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required. . . .

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. . . . An auditor who gives shareholders means of information, instead of information, in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty.

"In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders, in certifying and laying before them the balance-sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words, 'The value of the assets as shown on the balance-sheet is dependent upon realisation. . . .' It is a mere truism to say that the value of loans and securities depends upon their realisation. We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion. But, as already stated, the duty of an auditor is to convey information, not to arouse enquiry, and although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it."

In the course of his judgment, Rigby, L.J., said:—

"The words 'as shown by the books of the company' seem to me to be introduced to relieve the auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the balance-sheet with the entries in the books. Now, a full and fair balance-sheet must be such a balance-sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view."

In the case of *Pendleburys Ltd.* v. *Ellis, Green & Co.* (1936, Acct., 28th March, 1936, p. 480, *et seq*), it was held that where the directors of a private limited company are the sole shareholders, a report to the directors made by the auditors will discharge the liability of the latter to give similar information in their report to the members. In the course of his judgment, Mr. Justice Swift stated that, when having

regard for the duties which an auditor owes to the members some distinction must be drawn between a company with a large number of shareholders and one with two or three shareholders who happen also to be the directors.

(c) In re The Kingston Cotton Mill Co., Limited (No. 2). (1896, 1 Ch. 331.)

Held—THAT IT IS NOT THE DUTY OF THE AUDITOR TO TAKE STOCK; AND THAT HE IS NOT GUILTY OF NEGLIGENCE IF HE ACCEPTS THE CERTIFICATE OF A RESPONSIBLE OFFICIAL IN THE ABSENCE OF SUSPICIOUS CIRCUMSTANCES.

This case was heard after it had been determined by the Court of Appeal that the auditors of the company were officers of the company within the meaning of the Companies (Winding-up) Act, 1890 (*In re Kingston Cotton Mill Company, Ltd.* (No. 1), 1896, 1 Ch. 6). So far as this point of view is concerned, the case has already been considered in Chapter VI, § 2 (*b*).

This was an appeal by the auditors of the Kingston Cotton Mill Company, Ltd. (then in liquidation), against an order made by Vaughan Williams, J., under Section 10 of the Companies (Winding-up) Act, 1890 (now Section 333 of the 1948 Act), under which they were made liable to contribute to the assets of the company a sum equal to the moneys of the company improperly applied in payment of dividends on the faith of certain Balance Sheets examined by them. The profits of the company were increased fictitiously by deliberate manipulation of the quantities and values of the stock-in-trade, and the question was whether the auditors were guilty of negligence in

accepting the certificate of the manager as to the correctness of the stock-in-trade without checking the stock in detail. The facts of the case appear sufficiently from the following extract from the judgment of Lindley, L.J. (Acct. L.R. 1896, 77).

"For several years frauds were committed by the manager, who in order to bolster up the company and make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills. . . . The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance-sheet, and they took the values of the stock-in-trade at the end of the year from the stock journal. The book contained a series of accounts under various heads purporting to show the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts showing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shown by it was adopted by the auditors and was inserted as an asset in the balance-sheet, but 'as per manager's certificate.' The summary always corresponded with the accounts summarised, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarised. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the balance-sheet showed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of the auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance-sheet."

Lopes, L.J., in the course of his judgment made the following remarks :—

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful. . . . The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of auditors extended any

further than in *In re The London & General Bank* (*supra*), indeed, I only assented to that decision on account of the inconsistency of the statement made to the directors with the balance sheet certified by the auditors and presented to the shareholders. This satisfied my mind that the auditors deliberately concealed that from the shareholders which they had communicated to the directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable."

(d) The Irish Woollen Co., Limited, *v.* Tyson and Others. (1900, Acct. L.R. 13.)

Held—THAT AN AUDITOR IS LIABLE FOR ANY DAMAGE SUSTAINED BY A COMPANY BY REASON OF FALSIFICATIONS WHICH MIGHT HAVE BEEN DISCOVERED BY THE EXERCISE OF REASONABLE CARE AND SKILL IN THE PERFORMANCE OF THE AUDIT.

This case was heard before the Irish Court of Appeal, and was an appeal by Mr. Edward Kevans, the auditor, against the judgment of the lower Court, holding him responsible for the non-detection of the fraud. The appeal was dismissed.

The frauds were principally occasioned by the suppression of invoices outstanding at the date of the Balance Sheet, thus reducing the amount of purchases and the amount of creditors. The goods, however, were taken into stock and a fictitious profit was therefore shown to that extent. This amounted ultimately to £4,095.

The Court gave considerable weight to the fact that a special arrangement was come to between the company and the auditor, for a monthly audit to be conducted, which should lead up to the half-yearly audit. This monthly audit consisted merely in checking the current details and did not involve the preparation of monthly Profit and Loss Accounts or Balance Sheets.

In the course of his judgment, Holmes, L.J., said—

"Mr. Kevans seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it; the investigation of the books he deputed to his assistants . . . and it must be on the faith of their representations that he certified the balance-sheets. I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself. The auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy. . . . There is no doubt that both the suppression and carrying over of invoices would have been detected if the auditor had called for the creditors' statements of accounts upon which payment was ordered, and compared them with the ledger. I should have thought this was part of the auditor's duty for many reasons; but . . . apart altogether from the statements of account and the monthly check, I do not understand how the carrying over of the invoices could have escaped detection by the accountant, who should have used due care and skill, and who was not a mere machine. The invoices carried over were ultimately posted to the ledger. If they were posted to their true dates, it would be at once apparent that they were not entered in at the proper time. If they were posted under false dates, why was this not detected when the ledger accounts were checked with the invoices? And when no invoices came into the books, it is admitted that this ought to have excited suspicion. For these reasons I am of opinion that if due care and skill had been exercised, the carrying over and the suppression of invoices would have been discovered, and the auditor is liable for any damage the company has sustained from the understatement of liabilities in the balance-sheet due to this cause since January 4th, 1892. I consider that not only are Mr. Kevans and his assistants not free from blame for this, but also for the mechanical way the audit was carried out."

(e) The London Oil Storage Co. Limited, *v.* Seear, Hasluck & Co. (1904, Acct. L.R. 30, 93.)

Held—THAT THE AUDITOR IS LIABLE FOR ANY DAMAGE SUSTAINED BY A COMPANY BY REASON OF HIS OMISSION TO VERIFY THE EXISTENCE OF ASSETS STATED IN THE BALANCE SHEET.

This was an action brought by the company for damages for alleged neglect by the auditor in omitting to verify the existence of a sum of £796, shown in the Balance Sheet as petty cash in hand. As a fact, the balance in hand was only £30, and the difference had been misappropriated by the secretary, who kept the Petty Cash Book.

The auditor's clerk did not count the balance of cash in hand, but merely referred to the Petty Cash Book, to see that the amount shown in that book agreed with the amount shown in the Balance Sheet.

This case was heard before Alverstone, C.J., and a special jury, with the result that the jury found that the auditor had committed a breach of duty, and assessed the damages at five guineas. The jury considered that the directors had been guilty of gross negligence in allowing such a large balance of cash to remain in the hands of the petty cashier, and it was owing to this fact that the damages given against the auditor were of such a nominal amount.

In the course of his summing-up, Alverstone, C.J., said :—

"The auditor most undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties, or by want of reasonable care, he neglects his duty, and damage is caused to the company as such, he is responsible for that damage. . . . The plaintiffs must satisfy you that the damage has been occasioned, to whatever extent you think it was occasioned, by the breach of duty on the part of the auditor. . . . The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by the man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans*, which contributed to, but would not be the cause of, the loss. . . . Was he guilty of breach of duty, and, if so, what loss was occasioned to this company by that breach of duty ? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company."

(f) Arthur E. Green & Company, *v.* The Central Advance & Discount Corporation Ltd. (1920, Acct. L.R. LXIII, p. 1.)

Held—THAT AN AUDITOR IS GUILTY OF NEGLIGENCE WHEN HE ACCEPTS A SCHEDULE OF BAD DEBTS FURNISHED BY A RESPONSIBLE OFFICIAL, ALTHOUGH IT IS APPARENT THAT OTHER DEBTS NOT INCLUDED IN THE SCHEDULE ARE ALSO IRRECOVERABLE.

This case is of importance in that it shows that an auditor is not entitled to rely upon the statement of an official, however apparently trustworthy, where, but for the confidence reposed in him, it should be evident that his statement is inaccurate.

The defendant company were moneylenders against whom the auditors claimed the fees due to them. The defendants counter-claimed for negligence and were awarded damages.

The plaintiffs had audited the company's books for many years, and over a considerable period worthless debts to the value of nearly £19,000 had accumulated. Some of these debts had been outstanding for a number of years and a great proportion were actually statute-barred, and therefore should have been regarded for all practical purposes as irrecoverable.

The auditor accepted the figures supplied by the managing director and the board as to the amounts to be written off for bad and doubtful debts each year. The managing director had explained his reason for allowing old debts to remain on the books by saying that in a moneylending business it did not matter how old the debts were, because people would come back and pay in order to be able to obtain further advances. Such an explanation, in the opinion of Shearman, J., was not a satisfactory one. On no occasion did the auditor refer to the state of the book debts in his report to the members.

His Lordship said that if there were circumstances which seemed to call for enquiry, the auditor must make the proper enquiry, and if he did not take the proper steps to have the matter sifted, he did not fulfil the duty he owed to the company as one of its officers.

In the case of *Scarborough Harbour Commissioners* v. *Robinson, Coulson, Kirby & Co.* (1934, Acct. L.R. 65), the Court of Appeal reversed the decision of the lower Court which had found the auditors guilty of negligence in failing to report to the Harbour Commissioners that a debt due to them appeared to be bad. It was shown that the auditors had reason to believe that the state of the debt in question was known to the Commissioners and that their policy was not to press immediately for payment. The Master of the Rolls in the course of his judgment laid emphasis on the fact that all the circumstances of the case must be considered, and said "it is difficult to reconstruct the circumstances, but, having regard to all the facts of the case, it appears to me that the charge has not been made out."

(g) In re The City Equitable Fire Insurance Co., Ltd. (1924, Acct. L.R. 53 and 81.)

This was an action brought by the Official Receiver as liquidator of the company under Section 215 of the Companies (Consolidation) Act, 1908 (Section 333 of the 1948 Act), against the directors and auditors for damages arising out of misfeasance. The case was heard before Mr. Justice Romer, who dismissed the action both against the directors and the auditors. The Official Receiver did not proceed with any appeal so far as the directors were concerned, but took the case against the auditors to the Court of Appeal, where the judgment of the first Court was unanimously confirmed and the auditors were held not to be liable.

The City Equitable Fire Insurance Company, Ltd., carried on re-insurance business. The chairman was also the senior partner in the firm of Ellis & Company,

the company's stockbrokers, who at all material times were very heavily indebted to the company.

The charges against the auditors were ultimately confined to the contention that they were guilty of negligence in respect of the audit by them of the Balance Sheets of the company for the years ended 28th February, 1919, 1920 and 1921 respectively, under the following three heads :—

(1) Their misdescriptions in the Balance Sheets of the debts of Ellis & Co., and Mansell (the company's general manager) by including them under "Loans at call or short notice," or "Loans," or in the case of part of Ellis & Co.'s debt, under the heading of "Cash at Bank and in hand," and their consequent failure to disclose to the shareholders the existence of those debts.

(2) Their failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of each of the Balance Sheets than were so included.

(3) Their failure to detect and report to the shareholders the fact that a number of the company's securities, which were in the custody of Ellis & Co., were being pledged by that firm to its customers.

In the course of his judgment Mr. Justice Romer referred at some length to the duties of auditors as laid down by the judgments in *re London & General Bank* and *Leeds Estate Building and Investment Co.* v. *Shepherd*, referred to above, and stated that generally speaking the auditors in this case had displayed great care, skill, and industry in the discharge of their duties. He added, however, that if, even in any one instance,

the auditors had fallen short of their strict duty they could not be excused merely because in general they had displayed the highest degree of care and skill.

With regard to the first charge, the judge held that the sums in the hands of Ellis & Co. ought not to have been described as "Cash at Bank and in Hand," but that no damages flowed from this misdescription, as he considered it would have made no difference to anyone, in the circumstances of the case, had the item been included under the heading of "Loans" or of "Sundry Debtors."

In dealing with the question of loans, he pointed out that if directors choose to lend monies to their brokers or their general manager, there is no reason why they should not do so, nor did he see any reason why the auditors should call the attention of the shareholders specifically to the fact of their having done so, although they must take care that they did not bring into the Balance Sheets at face value a debt that is not a good one. On this point he considered that on the evidence before them there were no grounds upon which the auditors were entitled to assume that at the time of the audit these debts were not good.

The second charge related to the fact that in consequence of the method of "window dressing" employed, much larger sums were in the hands of Ellis & Co. at the date of each Balance Sheet than appeared to be the case according to the books. This operation was effected by the nominal purchase of Treasury Bonds by Ellis & Co. shortly before, and a nominal resale immediately after, the close of each financial year of the company. In fact, these

securities were never in the hands of Ellis & Co., but were retained by the sellers as security for a loan against them to Ellis & Co. Similarly, in 1921, there was an alleged purchase and resale by Ellis & Co., of National War Bonds, both purchase and resale taking place a few days after the date of the company's Balance Sheet, although Ellis & Co. sent a bought note to the company recording the purchase as having taken place on the 25th of February. Ellis & Co. certified that they held these securities at the date of the Balance Sheet, and this certificate was accepted by the company's auditors.

The transactions were recorded in the company's books, and on examination in the light of after events it was apparent that the operations were of a "window dressing" character, but the judge held that the auditors had not been guilty of negligence in not detecting this from the books, having regard to the state of their knowledge at the date of each audit.

The third charge related to the failure of the auditors to detect and report to the shareholders the fact that a number of the company's securities in the custody of Ellis & Co. were pledged by that firm. The auditors relied upon the certificates of Ellis & Co. that these securities were held by them, and the question as to whether they were justified in accepting these certificates instead of inspecting the securities personally was dealt with at some length, and is of considerable importance.

In the course of his judgment Mr. Justice Romer said—

"That it is the duty of a company's auditor in general to satisfy himself that the securities of the company in fact exist and are in safe custody cannot, I think, be gainsaid. If authority for the proposition be required, it may be found in the passage from Lord Justice Lindley's judgment in the *London*

& General Bank case, which has already been referred to. The auditor in that case, amongst other things, 'saw that the bills and securities entered in books were held by the bank,' and this the Lord Justice plainly treated as being part of an auditor's 'legal standard of duty,' though he did not of course mean that in all cases the bills and securities should be lodged with the bank. He meant 'with the bank or in other proper custody.' Nor is it at all clear whether the Lord Justice meant that in all cases the securities should be personally inspected by the auditor. For an auditor may 'see' that the bank holds the securities in the sense that he satisfies himself of the fact. In the case of a responsible and reputable bank this, according to the evidence of Mr. Van de Linde, would seem to be the custom of auditors. But I think that it is a pity that there should be any such custom. It would be an invidious task for an auditor to decide as to any particular bank whether its certificate should be accepted in lieu of personal inspection. The custom, too, at once raises the question, much debated in the course of the evidence before me, whether the courtesy of accepting a certificate should be extended to an insurance company or a safe deposit company. Indeed, if once it be admitted that, in lieu of inspecting the securities personally, the auditor may rely upon the certificate of the person in whose custody the securities have properly been placed, the auditor would be justified in accepting the certificate of any official of the company who happened to be in charge of the safe in which the securities are placed, supposing such official to be a reputable and responsible person. At some time or other it will, I think, have to be considered seriously whether it is not the duty of an auditor to make a personal inspection, in all cases where it is practicable for him to do so, whatever may be the standing and character of the person or company in whose possession the securities happen to be. I do not, however, propose to investigate this question further upon the present occasion. *For an auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left.* Whenever such personal inspection is practicable, and whenever an auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter be put right at once, or, if his requirement be not complied with, to report the fact to the shareholders, and this whether he can or cannot make a personal inspection. The securities, retained in the hands of Ellis & Co. for periods long beyond the few hours in which securities must necessarily be from time to time in the possession of the company's stock-brokers, were not in proper custody. That Ellis & Co. were at all material times regarded, and reasonably regarded, by Mr. Lepine as a firm of the highest integrity and financial standing is not to the point. A company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be. There are of course occasions when, for short periods, securities must of necessity be left with the brokers, but the moment the necessity ceases the securities should be lodged in the company's strong room or with its bank, or placed in other proper and usual safe-keeping. In my judgment, not only did Mr. Lepine commit a breach of his duty in accepting, as he did from time to time, the certificate of Ellis & Co. that they held large blocks of the company's securities, but he also committed a breach of his duty in not either insisting

upon those securities being put in proper custody or in reporting the matter to the shareholders. This was negligence, and but for Article 150, it would be my duty so to declare and to order Messrs. Langton & Lepine to make compensation for all the damages that such negligence caused to the company, directing an inquiry to ascertain what those damages were. For it is settled by authorities that are binding upon me that an auditor is an officer of the company within the meaning of sect. 215 of the Companies (Consolidation) Act, 1908, though Mr. Stuart Bevan, while admitting that it was not open to him to argue the contrary in this court, reserved to his clients the right to contest the point in a superior one. But Article 150 in express terms includes the auditors of the company in the protection that it gives, and it must be taken to be one of the terms upon which the auditors were employed and gave their services. They are therefore protected, unless the negligence of Mr. Lepine in the matter was wilful. This it certainly was not, unless I am mistaken as to the true meaning of the phrase 'wilful negligence.' I have heard Mr. Lépine's evidence in the witness box, and I have inspected many of the numerous documents prepared by him for the purposes of the audits that he conducted. I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was. As against him and his partner, the application of the Official Receiver must accordingly be dismissed."

By the company's Articles the directors, auditors, secretary and other officers were to be indemnified against any liability attaching to them, unless the liability arose through their own wilful neglect or default. Such indemnification clauses are now void under Section 208, Companies Act, 1948.

The remarks of the Master of the Rolls on the question of the custody of securities are of great interest and are therefore quoted verbatim below.

The Master of the Rolls said—

"Now I come to the last point, part of which is contained in the third charge, and that is the failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of the balance-sheet, and the failure to detect and report that the securities were in the hands of Ellis & Co. Now upon that matter I want to say a word or two about the evidence. In fact Mr. Lepine inquired from the bank and got a certificate from the bank that a certain number of securities were there, and then he turned to Ellis & Co., and he got from Ellis & Co. under the signature of Ellis & Co. a certificate attached to the document, apparently not by Mr. Bevan but by one of the partners, a certificate that a number of securities were in the hands of the stockbrokers. It is said it was quite wrong to accept the certificate of the brokers, and we are asked to accept the evidence of Mr. Cash

and Mr. Van de Linde as meaning this, that you may accept the certificate of a bank apparently in all cases, but you may never accept the certificate of stockbrokers. I cannot agree that the evidence is so to be read, or is intended by the witnesses to be so understood. What I think the witnesses meant to express was this: Banks in ordinary course do hold certificates of securities for their customers; it is part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then a bank is a reputable bank, a bank which holds a high position, you may legitimately accept the certificate of that bank because it is a business institution in whose custody you would expect both to find and to put securities, and also it is respectable, but the fact that it calls itself a bank does not seem to me to conclude the matter either one way or the other. On the other hand, it may be said that it is the duty of an auditor not to take a certificate as to possession of securities unless from a person who is not only respectable—I should prefer to use the word 'trustworthy'—and also of that class of persons who in the ordinary course of their business do keep securities for their customers, and it may be said that a broker does not in the ordinary course of business keep securities for his customers, and therefore he is ruled out because the auditor ought not to accept from a person of that class, whether he be respectable or not, a certificate that he has got securities in his hands. Now, accepting the rule as stated, that it is right to find the securities in the hands of the bank whose business it is to hold securities, and applying the proviso that that bank must be one that is trustworthy, it seems to me that that rule may be a right rule to follow, and I think it is *prima facie*, but it is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stockbroker, because it seems to me in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stockbrokers securities for the purpose of their dealing with them in the course of their business. With a large institution like the City Equitable Company, with a very considerable amount of investments to make and investments to sell, it may well be that for the purpose of the convenience of all parties it may have been a useful method of business even if it had been examined with the most exiguous care, for the directors to decide that they would in the interests of their business leave securities of a considerable amount in the hands of their stockbrokers, who, I suppose, at that time held a position not less trustworthy or respected than the City Equitable itself. I therefore do not wish in any way by anything that I say to discharge the auditors from their duties as laid down in the *Kingston Cotton Mills* case; far less do I wish to discharge them from their duty of seeing that securities are held and only accept the certificate that they are so held from a respectable, trustworthy and responsible person, be that person the bank or be it somebody else; but in applying my mind to the facts of this case I am not content to say that simply because a certificate was accepted otherwise than from a bank therefore there was necessarily so grave a dereliction of duty as to make Messrs. Langton & Lepine responsible. I think in the light of the evidence which has been given it is for the auditor to use his discretion and his judgment, and his discrimination as to who he shall trust; indeed I think that is the right way to put a greater responsibility on the auditors.

"If you merely discharge him by saying he accepted the certificate of a bank because it was a bank you might lighten his responsibility. I think

he must take a certificate from a person who is in the habit of dealing with, and holding, securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate. Therefore I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but at the same time, I throw a burden upon him in respect of which the test of common sense can be applied, and common business habits can be applied, rather than a rigid rule which is not based on any principle either of business or common sense."

(h) Rex v. Kylsant and Morland. (1931, Acct. p. 109 *et seq.*)

This case, which came before the Courts during July, 1931, is of very considerable importance.

Criminal proceedings were taken against the chairman and the auditor of the Royal Mail Steam Packet Co., Ltd., under the Larceny Act, 1861, the allegation being that the chairman had issued false annual reports to the shareholders *with intent to deceive*, and that the auditor had been guilty of aiding and abetting in the issue of such false reports. Both the chairman and the auditor were acquitted of this charge, but the chairman, on a further charge, was found guilty of publishing a prospectus which he knew to be false in a material particular.

For some years the Royal Mail Co. had incurred actual trading losses, but their published accounts revealed considerable profits available for dividend. This position was largely brought about by the utilisation of taxation and other reserves created in past years and no longer required for the purposes for which they were made. These reserves were secret reserves, inasmuch as they were not disclosed in the accounts, and the only indication of the fact that such reserves were being used as an aid to the profits of the years in question were the words "after adjustment of taxation reserves" included in the omnibus item of income shown to the credit of the published Profit and Loss Account. It was shown that during the years 1921-1927 no less than £5,000,000

taken by the company to the credit of its Profit and Loss Accounts was the result of drawing upon secret reserves or taking credit for such non-recurring items as bonus shares received. It was alleged by the prosecution that the result of such adjustments was to cause shareholders to believe that the company was trading profitably, whereas in fact it was making losses.

In the course of his opening remarks the Attorney-General said that when an auditor signed accounts, and stated "to the best of my information this Balance Sheet is properly drawn up so as to exhibit a true and correct view of the company's affairs as shown by its books" he was stating something upon which the ordinary investor was entitled to rely.

The auditor was charged under Section 84, Larceny Act, 1861, with aiding and abetting in the circulation of a written statement or account which he knew to be false in a material particular. In this connection, Wright, J., said, in the course of his summing-up—

"What exactly does that mean? The conclusion I have arrived at is this—that it is not limited to a case where you point to a written statement or account and say, 'Here are certain figures and words which are false.' I think that is to narrow unduly the words 'in any material particular.' If it is true in that way it would shut out the type of fraud in connection with written documents and accounts which may be of the utmost importance—*the type of fraud where you have a document, not fraudulent in the sense of what it states, but in the sense of what it conceals or omits.*

"I think the language which is used means more than that. It will cover the case where you have a written statement or account which is false n no specific words or figures which it contains, but which is false in the way in which it may be formed.

"*You may say, referring to every word and every figure, there is nothing false about this or that, but the document as a whole may be false, not because of what it states, but because of what it does* NOT *state and because of what it implies.*

"Of course, that type of falsity, which is indeed the type of falsity in question here, is more difficult to establish than a case where you can point to a specific false word of a sentence. Where the falsity consists in fraudulent design to create a false impression you have got to show affirmatively that there was a deliberate attempt to create a false impression.

"If you have a definite falsehood then that speaks for itself."

Mr. Justice Wright pointed out that the section involved three things—a false written document, knowledge of the falsity by the person who put it forward, and intent to deceive.

Little was said at the trial about the Balance Sheet of the company, the main allegation being that the Profit and Loss Account contained information which was false in that it included "old" reserves without that fact being disclosed.

In his summing-up, Wright, J., made the following remarks in connection with secret reserves—

"We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding, in order to find out and elucidate these very special matters. It was said by a learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all ? "

With regard to the use of the words "adjustment of taxation reserves" Mr. Justice Wright said—

"Is this phrase sufficient ? Is it a proper intimation to the shareholder in the year 1926 of what has been going on in the company's affairs, in order to produce year by year, not only debenture interest and the interest on discounts and other things, but the preference dividend and the ordinary dividend ? .... I am reminding you, although I am sure you have it in your minds, that it is my duty to remind you of what appears to me to be the first question you have to consider, granting all this, was it false and misleading in all the circumstances to put forward to all the shareholders in the Balance Sheet* merely these words 'adjustment of

* These words actually appeared in the Profit and Loss Account, not in the Balance Sheet.

taxation reserves,' as a warning that these enormous sums were being drawn from these funds, the nature of which I must consider a little later ?"

In connection with the auditor's position in regard to secret reserves, the Judge said—

"If the accounts from which the dividends were being paid or the expenses were being met were being fed by undisclosed reserves, it seems very difficult to see how an auditor could discharge his duty of giving a true and accurate view of the correct state of the company's affairs without drawing attention to those facts, which were vitally important.

"No doubt an auditor in his important and delicate duties must use a certain amount of discretion, but whatever discretion he may feel justified in exercising, he must remember he is under statutory duty, and he may come under the penalties of law, if he fails in *that* duty. . . .

"The auditor is not concerned with questions of policy, but if he sees that there is something in the accounts to which he ought to draw the attention of the shareholders it is his duty to do so. Either he will not sign the certificate at all or he will sign it with some qualifications such as circumstances require.

"The question is not whether the two defendants or either of them have committed any breach of duty to the company, either as chairman or auditor. If a breach of duty has been committed in connection with the accounts, if there has been any negligence, anything for which the directors or auditor may be liable to the company, then that is a matter directly and entirely beyond your purview and consideration.

"You are not here dealing with questions of civil liability. For civil liability the appropriate remedy is an action for damages."

(i) In re The Westminster Road Construction and Engineering Co., Ltd. (1932, Acct. February, 1932, pp. 203—204.)

Held—THAT AN AUDITOR IS GUILTY OF MISFEASANCE WHEN HE FAILS TO DETECT THE OMISSION OF LIABILITIES FROM THE BALANCE SHEET IN CIRCUMSTANCES WHERE THEIR OMISSION SHOULD HAVE BEEN APPARENT. *Held also*—THAT AN AUDITOR IS GUILTY OF MISFEASANCE WHEN HE FAILS TO DETECT THE OVER-VALUATION OF WORK-IN-PROGRESS IN CIRCUMSTANCES WHERE AMPLE EVIDENCE IS AVAILABLE FOR THE PURPOSE OF CHECKING THE ACCURACY OF THE FIGURES GIVEN TO HIM.

This was an action brought by the liquidator of the company against the directors and auditors for the recovery of a dividend paid by the company. The dividend was paid for the year ended 31st March,

1928, the profits of that year being shewn by the accounts to be £3,458. It was contended by the liquidator that there had been no profits out of which a dividend could be paid, and that the profit shown by the accounts was created by understating the company's liabilities and overstating the value of work-in-progress. The auditors had also acted as accountants to the company. No charge of dishonesty was made against any of the respondents, the allegation being that they had failed in the proper discharge of their duties.

The claim against the directors was dismissed on the grounds that they had all believed in the Balance Sheet reported upon by the auditors. The action against the auditors succeeded.

In the course of his judgment, Bennett, J., said—

"If the auditor found that a company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval and that liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it became his duty to make specific enquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the Balance Sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had been omitted. The evidence has established to my satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this Balance Sheet."

With regard to the over-valuation of work-in-progress the expert evidence was that it was the duty of the auditor to check the value at which work-in-progress was shown in the Balance Sheet. The judge stated that he was satisfied that there was ample material in the possession of the company with which the auditor could have tested the accuracy of the figures given to him, and that he was guilty of negligence in failing to make use of such material.

§ 5.—Legal Decisions Considered.

(a) Liability for Negligence under Common Law.

It has already been pointed out that it is extremely important for the auditor of a private firm to have a clear understanding with his clients as to the extent of his responsibility. This was illustrated in the case of *Wilde and Others* v. *Cape & Dalgleish* (1897, Acct. L.R. 81), where, owing to the auditors omitting to examine the pass book, frauds were not discovered. The defence in this case was that an audit of the cash transactions was not part of the original arrangement, but this could not be substantiated, and a settlement was arrived at.

A further instance of the auditor's liability in this connection is to be found in the case of *Smith* v. *Sheard* (1906, 34 Acct. L.R. 65). The defence in this case was that no agreement to perform an audit had ever been made, and that no audit was in fact conducted, with the result that the defalcations were not discovered. The defence, however, was not substantiated, and the auditors were held liable, although no certificate was placed by them on the accounts. The absence of such certificate, therefore, though it may have an important bearing on the result, will not of itself be sufficient to free the auditor from liability.

In the case of *Chas. Fox & Sons* v. *Morrish Grant & Co.* (1918, 59 Acct. L.R. 29), the accountants were employed to check the books and prepare accounts, but they did not examine the pass book, and were held liable for damages in consequence of defalcations arising which would have been discovered had the pass book been examined. The defence was that no audit was undertaken, and that it was not necessary to examine the pass book in checking the mathematical accuracy of the books and preparing accounts. The

Court held, however, that the checking of the books and the preparation of accounts in the circumstances in question, where "Cash at Bank" was inserted in the Balance Sheet by the accountants, implied a duty on their part to see that this asset actually existed.

In the case of *Martin* v. *Isitt* (1898, Acct. L.R. 41), a similar fraud took place. One of the terms of the contract for the audit was that it should be a monthly one, but although the fraud commenced in November, 1896, it was not discovered by the auditors until April, 1897, thus enabling the defalcations to be continued during that period. The defence was that the delay was occasioned by the state of the books, but a settlement was ultimately arrived at.

In the case of *Maritime Insurance Co., Ltd.*, v. *William Fortune & Sons* (1931, Acct. L.R. pp. 44—51), a claim was made against accountants for the non-discovery of defalcations. The defendants had certified the monthly returns made by a branch of the plaintiffs, and had at no time qualified their certificate in any way. It was alleged that not one of these returns accorded with the true facts, and had the accountants applied at least one of a number of tests (in particular an examination of the counterfoil paying-in-slips) they would have discovered the fraud. The defendants contended that they had been employed not to audit the books of the branch but merely to see that the monthly returns were correctly made out from the books kept by the company's servant, and that, therefore, unless they had reason to be suspicious it was not their duty to impose tests upon the accuracy of the records kept. Mr. Justice Roche stated in the course of his judgment that, in his view, according to the terms of the arrangements made between the accountant and the client,

the defendant's duties were limited to examining the books, seeing that they corresponded with the books that had to be kept, and in that sense seeing that they were adequately kept, and seeing that they were adequately summarised in the return to the head office. His Lordship also stated that there was no doubt that had the accountants' suspicions been aroused, it would have been their duty to report upon the matter, but in his view there was nothing which excited or ought to have excited their suspicions, and the claim therefore failed.

Another case in which the charge of negligence against accountants was not substantiated was that of *Leech* v. *Stokes* (1937, 81 Acct. L.R. 87), in which a claim was made against a firm of chartered accountants for damages for alleged negligence and breach of duty. The facts in this case were that the accountants had failed to detect misappropriations by the cashier of a firm of solicitors, of considerable amounts of rents collected by them for clients. No proper books of account were kept, there being no Cash Book nor a Clients' Ledger. The only book available was a Costs Furnished Book in which were entered particulars of the costs charged to clients and weekly summaries of the firm's expenses. From these particulars the accountants prepared Profit and Loss Accounts, but no Balance Sheets. On behalf of the defendants it was alleged that they were merely instructed to prepare a return of profits of the firm for income tax purposes, and that no investigation of the books was necessary or required for that purpose. Accordingly, they did not verify the transactions, nor carry out anything in the nature of an audit, neither was it possible, from the material available, to prepare Balance

Sheets. The first year's Profit and Loss Account was certified by the accountants to be in accordance with the books " subject to our report of this date," which was in the following terms :—

We have pleasure in enclosing Profit and Loss Account for the year ended 5th April, 1928. Costs and Agency Fees : This total has been compiled from the Costs Furnished Book, which, we are informed, includes all costs and fees furnished during the year. In accordance with your instructions, we have excluded the sum of £655 1s. 7d. as representing costs, etc., earned prior to 5th April, 1927, the date of the commencement of the present partnership. Office Outlay : The total expenditure during the year as shown by the weekly summaries amounted to £1,235 18s. 5d., of which the sum of £450 4s. 2d. represented sundry disbursements charged to clients. These latter have been deducted from the costs and agency fees as shown in your statements, leaving office expenditure amounting to £875 14s. 3d. If you approve of the account, we shall be pleased to forward a copy to the Inspector of Taxes on hearing from you.

The plaintiffs claimed that, as auditors, the firm of accountants should have verified the records before preparing the Profit and Loss Account, and should have prepared a Balance Sheet, and had they done so the defalcations would have been revealed.

In the course of his judgment, the judge stated that he was satisfied that a Balance Sheet could not have been prepared in the absence of a Clients' Ledger and Cash Book, and that if a Balance Sheet had been necessary, apart from being a reasonable and a desirable requirement, which might or might not have been dispensed with, it would have been necessary to write up the Cash Book and a Clients' Ledger. The accountants advised their clients that proper books ought to be kept and a Balance Sheet prepared, and even provided a set of books in which they made the opening entries, but when they next attended, the Clients' Ledger had not been written up, on the grounds that the cashier was overworked.

His Lordship found that " the instructions given to the defendant firm were to prepare a report of

profits for the Inspector of Taxes" and that "in this case there was no proper book-keeping material available for the preparation of a Balance Sheet," and "that there was no actionable negligence or breach of duty on the part of the defendants in any of the matters relied upon."

In the case of *Armitage* v. *Brewer and Knott* (1932, Acct., p. 836), the auditors were found guilty of negligence consisting of their failure to detect defalcations perpetrated by manipulation of the wages records and petty cash vouchers. The case, which did not concern the audit of a limited company, turned very largely upon the exact arrangement made between the auditor and the client as to the work to be performed. In the course of his judgment Talbot, J., said :—

> "The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of all wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a vigorous check, and they did so because that is what their client wanted."

In the course of the hearing Talbot, J., declared "that it was the duty of auditors to be suspicious, that was what they were there for. If everybody was honest and careful, there would be no need for auditors." These remarks have been the subject of much comment in view of the judgment of Lindley, L.J., in *The Kingston Cotton Mill* case. It must, however, be remembered that a judgment must be read in conjunction with all the facts of the case; the plaintiff in the *Armitage* case was shown to have told the auditors at the time of their appointment that he wanted protection against petty frauds and the auditors undertook the work and gave the plaintiff the reassurances that he frequently asked for.

It is interesting to note that in this case the auditors were held responsible for the amount of the defalcations which arose subsequent to their failure to detect fraud with regard to petty cash in an earlier period. In a leading article referring to the case, appearing in *The Accountant* it was stated :—

"As we have said, however, the case gives a footing disadvantageous to the profession for applying the principle of consequential damage to audit claims, and one of our correspondents has pointedly stated a case of pure consequential damage, which merits careful consideration. Thus, if an auditor omits to detect a defalcation by an employee and in the following year, before there is a chance of any further audit, the employee, emboldened by having escaped detection, embezzles a larger sum, is the auditor liable both for the original embezzlement which he failed to detect and for the subsequent loss to the employer as well ?

"So far as we are aware there is no exact professional precedent...... .... Addressing ourselves then, with such help as we can get, to the questions set to us, the answer to our minds depends upon the character of the initial error or omission. A mere mistake will not render a professional man liable for its consequence, but if the negligence was of the same type as was alleged in the case under discussion, *i.e.*, omitting to detect a fraud which by the exercise of reasonable care an accountant would have detected, then we are inclined to think that a jury would take into account the consequential loss in their award of damages.............."

The whole question in these cases is as to the precise terms of the agreement, and unless the limitations of responsibility are very clearly defined between the parties, the accountant or auditor should regard himself as under as much responsibility as if he were conducting a complete audit.

The failure to detect defalcations was the occasion of the case of the *Astrachan Steamship Company, Ltd. and Others* v. *Harmood Banner & Son* (1900, Acct. L.R. 49), where an action was brought for damages for alleged negligence, which was ultimately settled in favour of the plaintiffs.

In the case of the *London Oil Storage Company, Ltd.* v. *Seear, Hasluck & Co.* (1904, Acct. L.R. 30, 93), it was held that it is the duty of the auditor of a

company to take proper steps to verify the existence of assets. The point arose in connection with the verification of the petty cash balance, which was shown by the books to be £796, but the amount in hand was actually found to be only £30. The auditor contended that his duties ended when he had seen that the entries in the books created an asset. The absurdity of such a contention is manifest, and it was found that the auditor had committed a breach of duty in not vouching the existence of the cash in hand. The damages against the auditor were assessed at five guineas, the jury stating that in their opinion the directors had been guilty of gross negligence in allowing so large a sum to remain in the hands of the petty cashier. This is important, as illustrating the point that the auditor is only liable for such damage as flows directly from the act of negligence complained of.

An auditor has been held liable for failing to detect fraudulent suppression, or carrying over of invoices for goods purchased, the Court holding in the particular circumstances that he ought to have discovered the fraud by the exercise of reasonable skill and diligence. This portion of the audit was not performed by the auditor himself, but by his clerks, and the Court stated that although the auditor is bound to give reasonable care and skill, this can also be exercised by his deputy. At the same time, if the deputy fails in his duty, the responsibility falls upon the auditor; and where such failure is due to lack of supervision on the part of the auditor, in allowing the details of the audit to be carried out in a mechanical way by his clerks, he must suffer the consequences (*The Irish Woollen Company, Ltd.* v. *Tyson & Others, supra*).

(b) Liability for Misfeasance under the Companies Act, 1948.

The term "misfeasance" implies a breach of trust or duty. The auditor of a company, therefore, commits a misfeasance if he is negligent in the performance of his duties, but he cannot be made liable in damages under Section 333 of the Companies Act, 1948, in the event of winding-up, unless such misfeasance has directly resulted in damage to the company.

This section merely provides a more expedient form of procedure and creates no substantial new safeguard for the interests of the company. Proceedings under the section must accordingly be founded upon circumstances which would give rise to a claim against the auditors at common law.

In the *London & General Bank* case it was proved that the auditor was aware of the serious position of the company, owing to the fact that large sums advanced to customers on Loan and Current Accounts were insufficiently secured, and he was also aware that interest on such advances was taken to the credit of the Profit and Loss Account, although such interest had not been paid or provided against. He reported upon this state of affairs to the directors, but failed to induce them to make the necessary alterations in the accounts, or to refrain from paying a dividend. Lindley, L.J., said that taking the Balance Sheet, Certificate, and Report together, the auditor stated the true financial position of the bank to the directors, and if this report had been laid before the shareholders he would completely have discharged his duty to them. The misfeasance in this instance consisted in not placing this information before the shareholders. It was pointed out by the learned judge that information, and means

of information, are not equivalent terms, and that a person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. An auditor who adopts such a course as this does so at his peril, and runs a very serious risk of being held judicially to have failed to discharge his duty. It is clearly the auditor's duty, therefore, in cases where the Balance Sheet is not in order, to report fully to the shareholders.

The auditor is not concerned whether the business of the company is prudently or imprudently conducted, and it is no part of his duty to give advice either to directors or to shareholders. Whether dividends are properly or improperly declared is immaterial to the auditor, provided he discharges his own duty to the shareholders.

The auditor's duty is not merely confined to verifying the arithmetical correctness of the Balance Sheet, and comparing it with the books. He must make proper enquiries to see that the books of the company themselves show the true position: at the same time, he is not bound to do more than exercise reasonable care and skill. He is not an insurer and he does not guarantee that the books do correctly show the true position of the company's affairs or that the Balance Sheet is accurate according to the books. The auditor must be honest, that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

The case of *In re the Kingston Cotton Mill Co., Ltd.*, No. 2 (*supra*), makes it clear that in the absence of

suspicious circumstances the auditor is not liable for the correctness of the stock-in-trade appearing in the Balance Sheet. In that case the stock-in-trade had been deliberately manipulated, and the auditors accepted the certificate of the manager as to the correctness thereof, without checking the stock in detail. The Court of Appeal held that they were not guilty of negligence in so doing; that it is not the duty of the auditor to take stock, and that he is entitled to rely upon other people for details of this nature. *In the absence of suspicious circumstances*, the auditor can rely upon the representations of trusted officials; he is justified in believing tried servants of the company, in whom confidence is placed by the company.

Lopes, L.J., said that auditors must not be held liable for not tracking ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company, and are undetected for years by the directors.

This decision is valuable, as defining, to some extent, the liability of the auditor, but it should be observed that the question as to whether or not the auditor may be held to have been negligent, will depend entirely upon the circumstances in each case; that this is so is confirmed by the decision in *Henry Squire* (*Cash Chemists, Limited*) v. *Ball, Baker & Co.*, and *Mead* v. *the same* (1911, Acct. L.R. 44, 25) and, in the Court of Appeal, *Mead* v. *Ball, Baker & Co.* (1911, Acct. L.R. 45, 33).

It was shown in the course of this case that stock sheets had been falsified for years, and that they contained numerous alterations, which, it was argued, should have caused suspicion. It was held that the

auditors had relied upon the certificate of a responsible official, and their suspicions had not been aroused in the course of their investigations, and that *in the given circumstances* there was nothing necessarily to arouse the suspicions of an auditor who had exercised the skill necessary in conducting the audit.

It has been shown clearly, however, by *In re The Westminster Road Construction and Engineering Co., Ltd.*, that an auditor must make the fullest use of all material available to him, and although it has been decided that he is not a stocktaker, and presumably not a valuer of work-in-progress, he will be guilty of negligence if evidence is reasonably available from which the over-valuation of work-in-progress could be detected and he fails to utilise such evidence.

It has already been pointed out that as a result of the disclosures in the American case of *McKesson v. Robins* (on page 177 *ante*) the accountancy profession in the U.S.A. has adopted as part of normal auditing practice some form of test check of the actual physical stock, but that this lead has not been followed in this country, although it has elicited a certain amount of support here.

Mere extracts from the decided cases dealing with the auditor's duty with regard to stock, must not be taken too literally, and applied to the verification of this asset irrespective of the circumstances. An auditor cannot rely upon the certificate of a trusted official in respect of stock without making *any* attempt to check its accuracy, particularly as the asset is one known to be susceptible of facile manipulation, and the auditor might be contenting himself with the assurance of a person, who was himself a party to the manipulation. It is realised that the verification

of stock is a matter of very considerable difficulty and that in but a few cases could an auditor make such an investigation as would enable him to be assured, without any possible doubt, of its accuracy. In all cases, however, some tests are available to the auditor and of these he must take the fullest advantage; if the tests made reveal no suspicious circumstances then, and only then, may he accept a certificate from some trusted official who is competent to give it. The tests which may in general be made have been set out in Chapter V, § 4 (c).

Similar remarks must be held to apply to other assets as is shown by the case of *Arthur E. Green & Co.* v. *The Central Advance & Discount Corporation Ltd.*

It is the duty of an auditor of a limited company to make himself acquainted with his duties under the Articles of the company and under the Companies Act for the time being in force, and this particularly applies to the passing of payments made by the directors *ultra vires.* Where such payments have been made, the auditor must be particularly careful to refer to them in his report to the members, since if this is not done it might be held that the company had suffered loss by reason of its having been unable to recover the amounts improperly paid away.

In the case of *In re Bolivia Exploration Syndicate* (1913, 30 T.L.R 146), where circumstances of this nature arose, but where the auditors had pointed out the facts or they had been disclosed on the face of the accounts, it was held that damage to the company had not been established and that the auditors had not been guilty of any breach of duty.

Again, in *Re S. P. Catterson & Sons Ltd.* (1937, 81 Acct. L.R. 62) where considerable defalcations by a servant of the company had not been revealed by the

audit, the auditors were acquitted of liability for negligence on the grounds that they had pointed out to the directors that the system of recording certain sales was unsatisfactory, and had recommended improvements, but these recommendations were not adopted. Mr. Justice Bennett, in reviewing the responsibility of the auditors, stated that the primary responsibility for the accounts of a company is with the directors, and in this case they were not a satisfactory team. He stated, "I have no doubt as to where the primary responsibility for finding out the defalcations of this man Spicer lies. It lies upon the shoulders of the man whose duty it was, as a director of this company, to collect from Spicer the cash that he received. If that man had done his duty in any degree at all, the frauds could not have been perpetrated in the way in which they were perpetrated." He came to the conclusion that the auditor was an honest man trying to do his duty, and that in view of all the facts of the case and the audit notes, the applicant had quite failed to satisfy him in respect of the matters charged, that there was any negligence.

The case of *In re The City Equitable Fire Insurance Co., Ltd.* (*supra*) is one of the most complicated and important cases which have yet been fought under what is now Section 333, and the detailed judgments are worthy of close study. The Court of Appeal followed the principles laid down in earlier cases as to the duties of auditors, and as full extracts from the judgments have already been given, there is no need to recapitulate the facts here.

The main point related to the auditors' duties in connection with the custody and inspection of securities. In this case the auditors did not inspect

the securities which purported to be in the hands of the company's brokers, but accepted from the brokers certificates that they held them, though in fact the securities either did not exist or if they did exist had been pledged. At the time the certificates were given the auditors had no reason to doubt the integrity and standing of the brokers in question.

Considerable arguments arose on the question as to whether the auditors were entitled to accept a certificate from a reputable bank, and also whether in any circumstances a certificate should be accepted from stockbrokers or other persons.

The Court of Appeal declined to lay down any hard-and-fast rule, but indicated that the auditor is entitled, in his discretion, to accept a certificate from a person who is in the habit of dealing with and holding securities and who, in the exercise of his best judgment, he considers a trustworthy person to give such a certificate. If the auditor is not satisfied on these points, he should require the company at once to obtain delivery of the securities, and failing this he should report the matter to the members.

Notwithstanding this, it would appear to be desirable that the auditor should actually inspect the securities in the custody of third parties wherever this is practicable, and, where this is not done, *should state in his report that he has accepted a certificate.* Where a certificate is relied on, it should state that the securities are held free from any charge or encumbrance.

(c) Criminal Liability.

There is no doubt that although the auditor of the *Royal Mail Steam Packet Co.* was found not guilty of the charges brought against him, auditors

were given serious warning of the dangers involved if full information was not given to the shareholders of the utilisation of secret reserves. The *Royal Mail* was a chartered company, but this did not affect the principle involved.

No doubts as to the information to be provided by the Profit and Loss Account any longer exists as the result of the Companies Act, 1948, but it is interesting to record the following extract from a leading article published in *The Accountant* after the case had been decided.

"The prosecution, though unsuccessful, has materially altered the map of the accountancy world. Things can never again be as they were. If we judge the situation aright auditors will not be content to run the great risks, the existence of which has been disclosed by the very occurrence of this case. The fact that the accusation was rendered possible is not disposed of by the want of success of the prosecution, and no auditor can happily contemplate the possibility that in future an experiment may be tried in similar, though perhaps different, circumstances, with himself as the victim. . . . We think it a little unfortunate that at the *Royal Mail* trial there was little or no discussion of the general functions of a Profit and Loss Account, for the fact that the Companies Act expressly refrains from giving any guidance has led auditors to believe that the account is intended simply to show shareholders that the amount intended to be distributed as dividend is within the limits from the legal point of view . . . it has not been the view of the accountancy profession that an auditor is under a duty to differentiate between the balances which go to make up the credit at Profit and Loss Account, so long as those balances are, from the legal point of view, properly distributable items. The responsibility for the prudence or imprudence of distributing the items has been regarded as exclusively within the province of the directors.

"It is true that the recent verdict of the jury has of itself done nothing to change that view of the situation, but we do not think that the matter will be left there. The assertions made in court by counsel and the comments made by the learned judge in his summing-up make it clear that public opinion has moved. The public now looks to the auditor for a further measure of protection. Shareholders now demand, if not an exact statement of the results of current trading, yet an assurance that the results disclosed by the accounts of the year are not widely different from those accruing from the ordinary trading processes of the year. If that be a true reading of the situation, new possibilities are, of course, opened up, and we do not think the profession will close its eyes to those possibilities; nor do we think that the argument that the *Royal Mail* case was exceptional in that the existence of current losses was not clearly brought out, will be allowed to deflect consideration from the wider and more general demand by the public for candour in statements of account."

CHAPTER XI

OTHER STATUTES AFFECTING AUDITORS

Besides audits under the Companies Act, 1948, which have been dealt with earlier, there are a number of other statutes affecting different classes of audits with which the auditor of such concerns should be familiar before entering upon his duties.

In this chapter it is intended to summarise the clauses of the principal Acts relating to the appointment and duties of auditors, and the accounts of the various undertakings concerned.

§ 1.—The Assurance Companies Acts.

(a) The Assurance Companies Acts, 1909 and 1946.

This Act applies to all persons or bodies of persons, whether corporate or unincorporate, not being registered under the Acts relating to friendly societies or to trade unions, carrying on within the United Kingdom the following classes of business: (*a*) life insurance; (*b*) fire insurance; (*c*) accident insurance; (*d*) employers' liability insurance; (*e*) bond investment business. With certain modifications the provisions of the Act were extended to marine, aviation and transit insurance business by the Assurance Companies Act, 1946.

Where the accounts of an assurance company are not subject to audit in accordance with the provisions of the Companies Act, the accounts of the company

must be audited annually in such manner as the Board of Trade may prescribe.

Every assurance company must prepare at the end of each financial year a Revenue Account and Profit and Loss Account and a Balance Sheet in the prescribed forms. The form of Revenue Account for marine, aviation and transit insurance business is set out in Part I of the First Schedule to the Assurance Companies Act, 1946.

(b) The Industrial Assurance Act, 1923.

The Industrial Assurance Companies Act, 1923, restricts the carrying on of industrial assurance business to collecting societies (under the Friendly Societies Act, 1896), and to assurance companies within the meaning of the Assurance Companies Act, 1909.

"Industrial Assurance Business" means the business of effecting assurances upon human life, premiums in respect of which are received by means of collectors at intervals of less than two months.

Under the rules of a collecting society a separate account must be kept of all receipts in respect of industrial assurance business transacted by the society, and carried to a fund under the name of the Industrial Assurance Fund. The investments of such fund need not, however, be kept distinct from the other investments of the society. A separate valuation of industrial assurance business is, however, provided for.

Where an assurance company under the Assurance Companies Act, 1909, carries on industrial assurance business, the provisions of that Act relating to life

assurance business shall also apply to industrial assurance business. When any expenses of management or interest or dividends from investments, or sums on account of depreciation of securities, are apportioned between the industrial assurance business and any other business transacted by the company, the auditor shall include in his report a special report as to the propriety or otherwise of the apportionment. A copy of every report of the auditor shall be furnished to the Industrial Assurance Commissioner.

The accounts of collecting societies are subject to audit by a public auditor under Section 26 of the Friendly Societies Act, 1896, and copies must be filed with the Chief Registrar under Section 27 of that Act. The accounts of industrial assurance companies come under the Assurance Companies Act, 1909.

§ 2.—Friendly Societies Acts.

Under Section 26 of the Friendly Societies Act, 1896, every registered society and branch shall once at least in every year submit its accounts for audit either to a public auditor or to two or more persons appointed, as the rules of the society or branch provide.

Under Section 27 every registered society or branch must send to the Registrar of Friendly Societies a return of the receipts and expenditure, funds and effects of the society or branch as audited in prescribed form.

The auditors shall have access to all the books and accounts of the society or branch, and shall examine the Annual Return mentioned in the Act, and verify

the Annual Return with the accounts and vouchers relating thereto, and shall either sign the Annual Return as found by them to be correct, duly vouched and in accordance with law, or specially report to the society or branch in what respect they find it incorrect, unvouched, or not in accordance with law.

The public auditors above mentioned are appointed by the Treasury, and their remuneration is fixed by the Treasury, but the employment of these auditors is not compulsory, and in many cases the societies prefer to have their accounts audited by their own members.

Any person desiring to be appointed a public auditor under this Act must make a written application to the Registrar of Friendly Societies, stating—

(*a*) His full name.

(*b*) His occupation.

(*c*) His address.

(*d*) His professional qualification as an accountant.

(*e*) That he has no other employment in connection with such societies.

(*f*) His reason for thinking that his appointment of public auditor in that district would be in the public interest.

§ 3.—Building Societies Acts.

Under Section 16 of the Building Societies Act, 1874, it was provided that the rules of every society should provide for an annual or more frequent audit of the accounts; and for inspection by the auditors of the mortgages and other securities belonging to the society.

Under Section 3 of the Building Societies Act, 1894, it is provided that notwithstanding anything in the rules of any society, one at least of the auditors must be a person who publicly carries on the business of an accountant.

Section 2 of the same Act provides that every auditor in passing any annual account or statement must either certify that it is correct, duly vouched, and in accordance with law, or specially report to the society in what respect he finds it incorrect, unvouched, or not in accordance with law, and must also certify that he has at that audit actually inspected the mortgage deeds, and other securities belonging to the society, and must state the particular properties in respect of which deeds have been produced to, and actually inspected by him.

Under the same Section every annual account and statement must be made up in such form, and contain such particulars as the Chief Registrar of Friendly Societies may from time to time direct. The Section sets out particulars which the form must disclose.

§ 4.—Industrial and Provident Societies Acts.

The audit of industrial and provident societies is governed by Section 13 of the Industrial and Provident Societies Act, 1893, as amended by the Industrial and Provident Societies (Amendment) Act, 1913. Under Section 2 of the 1913 Act, every registered society shall once in every year submit its accounts for audit to one or more of the public auditors appointed under the provisions of the principal Act. No auditor shall hold any other office in connection with the society.

Under Section 4 of the 1913 Act, every registered society shall once in every three years make out and send to the Registrar with the Annual Return for the year, a special return signed by the auditor or auditors showing the holding of each person in the society (whether in shares or loans) at the date to which the said Annual Return is made out, distinguishing such persons by names or by numbers according to the system employed by the society.

Under Section 13 of the Industrial and Provident Societies Act, 1893, the auditor is empowered to have access to all the books, deeds, documents and accounts of the society, and shall examine the Balance Sheet showing the receipts and expenditure, funds and effects of the society and verify the same with the books, deeds, documents, accounts and vouchers relating thereto, and shall either sign the same as found by them to be correct, duly vouched, and in accordance with law, or specially report to the society in what respect they find them incorrect, unvouched, or not in accordance with law.

Under Section 14 of the same Act, as amended by Section 3 of the Industrial and Provident Societies (Amendment) Act, 1913, every registered society must once in every year send to the Registrar an Annual Return in prescribed form of receipts and expenditure, funds and effects of the society as audited. A copy of the report of the auditors, and a copy of each Balance Sheet made during the period must also be sent.

Auditors of industrial and provident societies are public auditors and the conditions under which they serve are the same as for friendly societies.

§ 5.—Trustee Savings Banks Acts.

Under Section 6 of the Trustee Savings Banks Act, 1863, no savings bank can have the benefit of the Act unless in its rules and regulations it expressly provides that a public accountant or one or more auditors be appointed by the trustees and managers, but not out of their own body, to examine the books of the bank and to report in writing to the board or committee of management the result of such audit not less than once in every half-year; also to examine an extracted list of the depositors' balances made up every year to the 20th day of November, and to certify as to the correct amount of the liabilities and assets of the bank. The book containing the list of depositors' balances must be certified by the auditors.

§ 6.—Executors' and Trustees' Accounts.

(a) The Public Trustee Act, 1906.

Under Section 13 of the Public Trustee Act, 1906, the condition and accounts of any trust shall, on application being made and notice thereof given in the prescribed manner by any trustee or beneficiary, be investigated and audited by such solicitor or public accountant as may be agreed on by the applicant and the trustees, or in default of agreement by the Public Trustee or some person appointed by him. The section provides that an audit shall not be performed more than once a year except with the leave of the Court (Section 13 (1)). A beneficiary of a trust that is not administered by the Public Trustee may make application under this section. The Public Trustee may require the applicant to make a deposit sufficient to cover the costs of the investigation (Rule 32).

The auditor shall have a right of access to the books, accounts and vouchers of the trustees and to any securities and documents of title held by them on account of the trust, and may require from them such information and explanation as may be necessary for the purpose of his duties, and upon the completion of the investigation and audit shall forward to the applicant and to every trustee a copy of the accounts, together with a report thereon and a certificate signed by him to the effect that the accounts exhibit a true view of the state of the affairs of the trust, and that he has had the securities of the trust funds and the investments produced to and verified by him or (as the case may be) that such accounts are deficient in such respects as may be specified in such certificate (Section 13 (2)).

Copies of the report and certificate of the auditor together with the accounts and any other documents he may require must be sent to the Public Trustee, who will then make an order as to the expenses of the investigation (Rules 36 and 37).

If, in the course of the investigation, any person having the custody of any books or documents to which the auditor has a right of access, fails or refuses to allow him to have access thereto, or in any wise obstructs the investigation or audit, the auditor may apply to the Court, and thereupon the Court shall make such order as it thinks just (Section 13 (6)). Any application by the auditor under this section is made to the Chancery Division by an originating summons, and any order then made will be enforced by a subsequent application for leave to issue a writ of attachment, or for an order of committal for contempt of Court.

The remuneration of the auditor and the other expenses of the investigation and audit are to be determined by the Public Trustee who may refer the costs of any solicitor (being part of such expenses) for taxation (Rule 37).

Unless the Public Trustee otherwise directs, the auditor's remuneration and expenses shall be borne by the estate; but he may order that such expenses shall be borne by the applicant or by the trustees personally, or partly by them and partly by the applicant (Section 13 (5)). But the Public Trustee may in his absolute discretion, upon the application of any trustee or beneficiary, direct that the investigation and audit shall extend only to a specified period of time or to a specified part of the trust property, or shall be otherwise restricted (Rule 33).

The trustee cannot make terms before producing the necessary books or documents (*re Williams*, 1916, 26 T.L.R. 604). An appeal from the order of the Public Trustee in non-administrative matters may be made to the Court (*In re Oddy*, 1911, L.J. Ch. 404).

(b) The Judicial Trustees Act, 1896.

Under the Judicial Trustees Act, 1896, the accounts of every trust of which a judicial trustee has been appointed shall be audited once in every year, and a report thereon made to the Court by the prescribed persons. In all ordinary cases the accounts are audited by an officer of the Court, but the Court can refer them to a professional accountant for report if it considers the accounts are likely to involve questions of difficulty.

(c) **The Trustee Act, 1925.**

Under the Trustee Act, 1925, Section 22 (4), trustees may at their absolute discretion employ an independent accountant to audit the accounts of the trust property, but not more than once in three years, unless the nature of the trust or any special dealings with the trust property render a more frequent audit desirable.

§ 7.—Solicitors Acts, 1933 and 1941.

Section 1, Solicitors Act, 1941, requires every solicitor in practice to deliver to the Law Society every year a certificate signed by an accountant, stating whether the solicitor has complied with the provisions of the Solicitors' Accounts Rules. The Rules regarding the delivery of the certificate are set forth in The Accountant's Certificate Rules, 1946, and the form of certificate is given in the schedule thereto.

To be qualified to give a certificate on behalf of a solicitor the accountant must be a member of—

(*a*) The Institute of Chartered Accountants in England and Wales, or

(*b*) The Society of Incorporated Accountants and Auditors, or

(*c*) The Association of Certified and Corporate Accountants, or

(*d*) The Society of Accountants in Edinburgh, or

(*e*) The Institute of Accountants and Actuaries in Glasgow, or

(*f*) The Society of Accountants in Aberdeen.

The audit of solicitors' accounts and a consideration of the Rules are dealt with in some detail in Chapter XII.

§ 8.—The Transport Act, 1947.

The scheme of audit of the accounts of the British Transport Commission approved by the Minister of Transport under Section 94, Transport Act, 1947, on 1st July, 1948, is as under :—

1. In this scheme, unless the context otherwise requires, the following expressions have the meanings hereby respectively assigned to them :

"the Act" means the Transport Act, 1947 ;

"the auditors" means the auditor or auditors for the time being of the accounts of the Commission, appointed by the Minister under subsection (3) of Section 94 of the Act ;

"the Commission" means the British Transport Commission ;

"Executive" means an executive established by or under Section 5 of the Act ;

"financial year" means a year ending with the 31st December of that year ;

"the Minister" means the Minister of Transport.

2. The auditors shall examine the books, accounts and records of the Commission and shall report :

(*a*) whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit ;

(*b*) whether in their opinion proper books of account and other records in relation thereto have been kept by the Commission so far as appears from their examination of those books and records, and whether proper returns adequate for the purposes of their audit have been received from every executive and

department of the Commission, whose accounts have been examined and reported upon by such auditors or firms of auditors appointed by the Commission as are referred to in paragraph 3 of this scheme ; and

(*c*) (i) whether the Balance Sheet and Revenue Account for the financial year, and any other account required to be included in the Commission's annual statement of accounts for that year are in agreement with the said books of account and records, and with the returns examined and reported upon as aforesaid ; and

(ii) whether in their opinion and to the best of their information and according to the explanations given to them the said Balance Sheet gives a true and fair view of the state of the Commission's affairs at the end of the financial year, and the said Revenue Account gives a true and fair view of the operating results and the profit or loss for the said year, and any other such account gives a true and fair view of the matters to which it relates.

3. The Commission having expressed their intention of appointing, so far as is practicable, professional auditors or firms of auditors to audit on their behalf the books and records of the executives and departments of the Commission, the auditors are authorised, to the extent which is in their judgment reasonable, to rely for the purposes of their audit upon the audits carried out by any auditors or firms of auditors appointed by the Commission to carry out such audits, provided that :

(*a*) the auditors approve the general lines of the work carried out by any such auditor or firm of auditors ;

(*b*) the auditors are furnished by any such auditor or firm of auditors with answers to such inquiries and with such further information and explanations as they may require ; and

(*c*) the Commission comply with the provisions of paragraph 4 of this scheme.

4. The Commission shall maintain proper systems of internal check, and after consultation with the auditors, shall take steps to ensure the integration of the programmes of professional audit and the provision of such liaison as may be necessary between the auditors and such other auditors or firms of auditors appointed by the Commission as are referred to in paragraph 3 of this scheme.

5. This scheme may be revoked or varied by any later scheme approved by the Minister:

(*a*) as respects any financial year commencing on or after 1st January next following the date upon which the later scheme is so approved ;

(*b*) as respects any financial year commencing on or after the 1st January next preceding the date upon which the later scheme is so approved if that scheme is so approved not later than the 1st February in that year ; or

(*c*) if in exercise of his powers under subsection (3) of Section 94 of the Act, the Minister directs that the accounts of the Commission as respects any part of their undertaking specified in the direction shall be separately audited.

§ 9.—Miscellaneous Statutes.

(a) The Licensing Act, 1910.

Under Rule 62 of the Licensing Rules, 1910, the Compensation Authority must appoint a professional accountant, approved by the Secretary of State, to be the auditor of their accounts.

The auditor may be appointed for a term not exceeding three years, and his remuneration shall be such as may be fixed by the Compensation Authorities with the consent of the Secretary of State. The auditor must examine the annual financial statement, with the accounts and vouchers and certify the same, making any report that may be necessary.

(b) Territorial and Reserve Forces Act, 1907.

Under the regulations made by the Army Council, the accounts of every County Association must be audited by a professional auditor, appointed subject to the approval of the Army Council, who must be a member either of an Institute or Society of Chartered Accountants in the United Kingdom, or of the Society of Incorporated Accountants and Auditors.

CHAPTER XII

SPECIAL POINTS IN DIFFERENT CLASSES OF AUDITS

In addition to the general procedure which has been dealt with at length in preceding chapters, special points arise for consideration in each different class of audit. It is not possible to deal with every kind of business, and discuss in detail the various special points that have to be considered, owing to the limits of available space. It is proposed to select some of the representative classes of audits, and indicate the important points that require the auditors' consideration.

§ 1.—Assurance Companies.

In the case of a life insurance company the premium income should be vouched with the policy books, renewals register, lapsed policies, etc., from which it should be possible to verify the premium income in total by taking the gross premium income receivable and deducting premiums on policies matured, surrendered, or lapsed.

The agents' commissions should be vouched with the receipts, agents' accounts, etc., and it should be seen that no commission is paid in respect of business introduced to the head office without the intervention of an agent. The commission outstanding must be brought into account. Some of the accounts in the Agents' Ledger should be tested with the returns from the agents.

The claims should be tested with cancelled policies, death certificates, discharge notes, etc., and it should be seen that all claims notified but not admitted are provided for.

Surrenders should be tested with indorsed policies and receipts for cash ; payments to annuitants should be tested, and it should be seen that the proportion of annuities accrued to the date of the Balance Sheet is brought into account.

The re-insurances and re-insurance recoveries should be checked, and it should be ascertained that all outstandings on this account are provided for. It should be seen that the premium reserve carried forward is adequate. The verification of the securities, and the income derived therefrom, will follow the usual lines.

Similar considerations apply to fire, accident, and other insurance companies. The claims should be tested with the papers relating thereto, and it should be seen that all claims notified but not admitted are provided for.

The adequacy of the premium reserve carried forward should be fully inquired into, having regard to the nature of the business transacted, and the past experience of the company.

In the case of re-insurance companies, the treaties with the ceding companies should be examined, with particular reference to any provisions under which the ceding company is entitled to retain funds as security for the fulfilment of the treaties. Where this is the case, certificates should be obtained from the companies concerned of the funds held by them, and they should appear separately in the Balance Sheet of the re-insurance company as "Deposited as security under Treaties," with an indication

as to whether the assets concerned are under the control of the ceding companies, or in joint names or otherwise.

The accounts of the ceding companies should be tested and the outstanding balances agreed; similarly, treaties made by the re-insurance company with other companies, under which they may concede a portion of the re-insurances received by them, should be examined, together with the accounts relative thereto.

In the case of a life assurance company carrying on industrial assurance business, reference should be made to Chapter XI, § 1, where the subject is dealt with in reference to the Industrial Assurance Act, 1923.

The accounts should be drawn up in the form prescribed by the Assurance Companies Act, 1909. The Balance Sheet must state how the values of the stock exchange securities are arrived at, and a certificate must be appended signed by the same persons as signed the Balance Sheet, to the effect that in their belief the assets set forth in the Balance Sheet are in the aggregate of the value stated therein less any investment reserve fund taken into account.

Where separate funds are required to be kept, the certificate must be appended, signed by the same persons as signed the Balance Sheet, and by the auditor, to the effect that no part of any such fund has been applied directly or indirectly for any purpose other than the class of business to which it is applicable.

§ 2.—Banks.

In the case of a bank it is of the utmost importance that a complete system of internal check should be

in operation, and the auditor should obtain a written statement thereof.

The following is a summary of the more important points in such a system :—

(1) The ledger clerks should be changed about from time to time without previous notice.

(2) Each clerk should be required to take his annual holiday at one time without a break.

(3) The cashiers should not have access to the customers' ledgers.

(4) The ledger clerks should have no access to the Cash Book, or the Clearing House Journal.

(5) The Cash Book should from time to time be compared with the actual records by independent and responsible officials, and subsequently with the ledgers.

(6) No ledger keeper should be a party to testing his own work.

(7) The periodical balancing of customers' accounts with the General Ledger should be performed by independent officers selected by the accountant.

(8) At intervals the testing of the ledgers should include the "sides" of the accounts in addition to the extended balances, thus affording a comparative check with the Total Summation Book, to which the aggregates of payments and cheques are posted day by day.

(9) The branches should be subject to frequent audits without notice by travelling auditors or inspectors.

(10) An occasional audit by the bank's inspector should be in force in respect of the head office in the same manner as the branches.

(11) Neither cashiers nor ledger keepers should participate in the preparation or checking of bank pass books, which should be checked by the bank's officials independently of the auditors.

Where customers' accounts are kept on a mechanised system, some modification of the above details will be necessary, since the ledger accounts are written up by machine operators, who take the place of ledger clerks, whilst the pass books are displaced by loose leaf statements, which are retained by the bank's customers. Analogous features should, however, be incorporated in the system of internal check to ensure that misappropriation of cash and falsification of accounts can only be committed by collusion between two or more clerks, and to minimise the opportunities for such collusion.

The auditor should attend at the close of business on the day of the Balance Sheet, and count and weigh the cash in hand. Certificates should be obtained for the cash at the Bank of England and other banks. The cash articles should be verified ; these are cheques etc., received too late on the last day of the accounts to be cleared, and can be vouched by seeing that they come through in due course within the next few days.

Money at call and at short notice is usually represented by advances to bill brokers on the deposit of bills from day to day, and to stockbrokers on the deposit of securities from account to account. The bills should be examined, and the securities lodged by the stockbrokers checked with the schedules appended to the borrowing notes.

The investments of the bank must be examined, special precautions being taken to prevent the same

securities being produced twice. The schedule of investments should show the book value and the market price on the day of the Balance Sheet, and it should be seen that sufficient reserve is made if the total book value is in excess of the market value.

Bills in hand should be examined, and it should be seen that proper provision is made for rebate, representing the proportion of discount not earned at the date of the Balance Sheet.

The securities deposited against loans and overdrafts should be examined, and it should be seen that sufficient margin is provided. The ledger balances on current, deposit, and loan accounts should be checked, and it should be seen that sufficient reserve has been made for bad debts.

If the auditor is not instructed to visit the branches he should examine the certified returns, and see that they are properly incorporated in the head office books, qualifying his report to the members accordingly.

Banks usually possess large secret reserves, which should receive the auditor's attention. This subject has been discussed in Chapter VII, § 16.

§ 3.—Branch Accounts.

In the case of a business possessing branches, the auditor should ascertain the system upon which the branch accounts are recorded, and the manner in which they are incorporated in the head office books. Where he is not instructed to visit the branches, he should examine the returns furnished by them, which should in each case be duly certified by the branch manager, and ascertain that they are properly incorporated in the head office books. He cannot

in such a case be held responsible for the correctness of the branch accounts, and he should limit his responsibility by stating in his report that he has accepted the certified returns sent from the branches.

The auditor should, however, satisfy himself that all questions of principle, such as the valuation of stocks, provisions for depreciation, bad debts, etc., have been properly dealt with by the branches.

In the case of retail branches it is usual to find goods supplied by the head office charged out either at cost price, at cost price plus a percentage, or at selling price, stocks in each case being taken on a similar basis, and in the two last cases the auditor should see that the values of the stocks have been reduced to cost for Balance Sheet purposes. Schedules of debtors at the branch should be submitted, duly certified, and the auditor should ascertain that all liabilities at the branch not already shown in the head office books have been brought into account.

The balances on the branch accounts will in such cases usually be represented by stock on hand, sundry debtors, and cash in hand, and for the purpose of the final Balance Sheet the branch balances must be incorporated in the amounts of the particular assets of which they are respectively composed.

Where a complete set of books is kept at each branch, and only a current account with the branch kept in the head office books, the auditor should have produced to him, either the Trial Balance of the branch or the branch Profit and Loss Account and Balance Sheet. In such a case the balance of the Branch Current Account in the head office books will represent the capital employed at the branch, and will be made up of the assets at the branch less

the liabilities. These should be incorporated in the final Balance Sheet under their respective headings. In no case should the balance to the debit of the Branch Account be treated as a debtor.

All cash remitted from the branch, as shown by the branch accounts, should be vouched into the head office books, and similarly all cash remitted from the head office should be vouched into the branch accounts. Items of cash or stock in transit should be vouched by ascertaining that they have been received subsequently.

In the case of foreign branches the question of exchange will arise in addition to the above-mentioned points, and the auditor should check the conversion of the various items into sterling, and ascertain that the difference on exchange has been properly dealt with. Where the exchange is of a fluctuating character, the following rule is frequently adopted: fixed assets are converted at the rate prevailing when they were acquired, if purchased out of currency funds, or at the cost of a special remittance sent by the head office for the acquisition; floating assets and liabilities at the rate at the date of the Balance Sheet; revenue items at the average rate of the period covered by the accounts; and remittances at the actual rates.

If each item of the Trial Balance is converted at its appropriate rate, the opening balance of the Head Office Current Account being replaced by the sterling figure at which it stands in the head office books, the difference on the sterling Trial Balance will represent the total difference on exchange. If the difference represents a loss, it should be written off; if a profit, it may be advisable to carry it forward against possible losses arising in a succeeding period.

Various other methods may be met with, and in each case the auditor must satisfy himself that the treatment employed is proper under the circumstances; if this is not so, he should deal with the matter in his report to the members.

In all cases where the auditor accepts certificates of officials or other persons for the verification of assets at branches, he should mention that he has done so in his report.

The appointment of local auditors to audit the accounts of branches has been considered in Chapter VI, § 1.

In the case of a company carrying on business abroad where the foreign branches are not visited by the auditor, he must state in his report that proper returns adequate for the purpose of the audit have been received.

§ 4.—Breweries.

The auditor should see that there is a proper system for dealing with "Floating Cooperage." This represents casks out with customers, and it should be seen that the value of these casks is not included in the book debts, but is stated separately.

The Beer Production Account should be examined with the official Excise Book, and it should be seen that the quantities approximately agree, subject to wastage.

Where there are managed houses, it should be seen that there is a proper system of check upon the managers; and that where the stocks of these houses are taken at selling price a proper adjustment is made back to cost price.

Loans to customers should be checked, and it should be seen that instalments of interest and principal are properly recorded, and that adequate provision is made against loans which may prove to be irrecoverable. In many cases the brewery will have guaranteed a loan obtained by the tenant, and it should be seen that the total amount of such contingent liabilities under guarantee is stated in the Balance Sheet.

The instalments on account of the Compensation Fund should be charged to revenue, and it should be seen that proper adjustment is made when compensation is received in respect of the cancellation of a licence. Where the amount of compensation exceeds the book value of the property, such profit should not go to the credit of Profit and Loss, but should be treated as a capital profit, against which can be set off corresponding losses. If the amount received is less than the book value, the loss is a capital loss, but it is advisable that it should be charged against revenue.

§ 5.—Building Societies.

In view of the frauds that have arisen in connection with the accounts of building societies, and the fact that the system of book-keeping in some of the smaller societies is not always adequate, the auditor should pay great attention to the internal check employed, and especially to the arrangements with regard to the custody of mortgage deeds and other securities.

The subsidiary and general Cash Books should be checked completely. The rents received from the properties in hand should be vouched, and it should be seen that they bear a reasonable proportion to the values of the properties in the books.

The pass-books, or a proportion of them, should be examined with the ledgers, care being taken to obtain those called for, and not those offered by the officials.

It should be seen that the amount received on deposit or loan does not exceed two-thirds of the amount secured to the society by mortgages on the property of its members.

The schedules of properties in hand should be compared with those of the previous year, and the proceeds of those sold verified; in a similar manner the schedules of advances should be compared, and the receipts for those repaid verified.

The Fire Policy Book should be examined, in order to ascertain that the insurance premiums on all the properties mortgaged to the society are paid up to date.

The securities held for loans on mortgage should be examined in the manner indicated in Chapter V, § 5. In the case of large societies, where the number of deeds is very considerable, and where boxes containing the deeds are kept at the bank or in the strong room of the society, and can only be opened by at least two of the trustees, utilising different keys, it is possible for the following procedure to be adopted: On the occasion of the first audit the whole of the securities must be examined. The deeds relating to each security should then be made up into packets, numbered with the number of the security as shown in the Register of Deeds, and sealed by the auditor with his private seal. On subsequent occasions only new deeds need be examined in detail, the production of the packets with the seals unbroken being sufficient evidence that

the securities are intact. Where the packets have been opened for the purpose of reference, the auditor must re-examine the securities, and re-seal the packets.

It should, however, be remembered that the auditor has to certify that he has actually inspected the mortgage deeds and other securities belonging to the society on the occasion of each audit, and therefore the adoption of any method such as that indicated above leaves the auditor open to some risk in the event of fraud being practised, and the auditor's seal forged and affixed to dummy packets. For this reason it is most desirable that the auditor should at least open a certain number of the packets at random, to afford some test against this possibility, and it may be more prudent actually to examine every packet at each audit.

The following is the form of Certificate required under Section 2 of the Building Societies Act, 1894 :—

> "We, the undersigned, being a person who publicly carries on the business of an accountant at No. Street and residing at the duly appointed auditors of the above-mentioned Society, do hereby attest the foregoing accounts and statements, and certify that they are correct, duly vouched, and in accordance with law, and we certify that we have at this audit actually inspected the mortgage deeds and other securities belonging to the Society, in respect of each of the properties in mortgage to the Society, referred to in the foregoing accounts and statements."

§ 6.—Charitable Institutions.

The income from donations and subscriptions should be checked into the Cash Book from the counterfoil Receipt Books. The auditor should see that all spoilt receipts are produced. The receipts should be

printed with the name of the charity, and numbered consecutively.

The receipts from legacies should be vouched with the Legacy Register, correspondence with the solicitors, etc.

Other income from investments, rents, etc., should be vouched in the manner described in Chapter II, § 4.

As charitable institutions are not liable to income tax, it should be seen that no tax has been paid, or where it has been paid by deduction, that it is duly recovered.

The printed list of subscriptions and donations should be checked and agreed with the total shown in the accounts. It should be seen that all funds left for specific purposes have been applied to those purposes.

§ 7.—Churches.

The Parochial Church Council Measure, 1921, requires the preparation of an Income and Expenditure Account, made up to the 31st December in each year, together with a Balance Sheet at that date. The accounts have to be audited and placed before the Annual Parochial Church Meeting held immediately after Easter.

The auditor should ascertain that all cash is duly banked, and where balances remain in the hands of treasurers or other officials, these should be counted. The Offertory Book should record the receipts from offertories, and the amount received should be initialled by the curate-in-charge or a churchwarden. It should be seen that all offertories for special purposes are properly dealt with.

The Freewill Offering System has been adopted in some churches. The auditor should see that a

proper system is in force for dealing with the contributions.

Pew rents, if any, should be vouched with the Pew Rent Register; and where the rents are divided between the vicar and the church, it should be seen that the allocation is properly made.

The church title deeds and securities representing endowment funds (if any), should be examined.

§ 8.—Clubs.

The entrance fees and annual subscriptions should be vouched with the counterfoil receipt books, and the total verified with the annual list of members, enquiry being made into those in arrear.

The steward's receipts should be vouched, and it should be seen that there is an effective system of check as regards the dining room, billiards, wines, cigars, etc. Proper stock accounts should be kept of wines, cigars, etc., and any wines which are not the property of the club, but of wine merchants, should be specially recorded as such.

The question of the depreciation and renewals of china, glass, linen, plate, etc., is important. Where the original expenditure is capitalised, all renewals should be charged to revenue; but perhaps the best method is to take stock of these items, and revalue them on the occasion of each Balance Sheet. Where heavy expenditure is incurred from time to time in redecoration of the premises, it is advisable that an annual amount should be provided against each year's accounts, in order that this expenditure may be fairly equalised.

The secretary of a registered club is required by law to furnish a statement to the Customs Authorities, in the month of January each year, showing

the club's purchases of intoxicating liquor during the preceding year.

If the accounts of the club have been audited by a person (other than the secretary of the club), who either publicly carries on the business of an accountant, or is a public auditor duly appointed under the Friendly Societies Act, 1896, a certificate signed by the auditor in the following form, or in words to the same effect, showing only the total amount of purchases (or of payments, as the case may be), during the year, and attached to the statement, will, as a rule, be accepted in lieu of a detailed account.

FORM OF CERTIFICATE.

I/we, the undersigned, of. . . . .
being a public auditor duly appointed under the Friendly Societies Act, 1896 (or a person who or a firm which publicly carries on the business of an accountant), hereby certify that I/we have examined the accounts of the.. . . ..club for the year ended the 31st day of December, 19 , and that the total costs of the purchases (or the actual payments made), in that year by the said club in respect of intoxicating liquors of all descriptions supplied in or to the club, or on behalf of the club to the members thereof, amounted to the sum of ... ...pounds, ... shillings and .. pence.

Dated this ..... . day of .. . . 19 .

(*Signed*) ... .

§ 9.—Contractors.

Under this heading may be included the accounts of contracting companies, builders, engineers, shipbuilders, etc., the bulk of whose work is carried out under contract conditions.

The auditor should examine the system of cost accounts in operation, as upon its efficiency will depend to a large extent the value of the accounts to the proprietors of the business. It is not within the province of this work to discuss in detail the question of cost accounts, but the auditor should ascertain

the system of dealing with wages and expenditure on stores, materials, etc., also the treatment of indirect expenditure, which is frequently termed establishment charges.

The item " Work-in-Progress " represents the value of uncompleted contracts at the date of the Balance Sheet, and a schedule showing how the amounts are arrived at should be presented to the auditor, duly certified. Where proper cost accounts have been kept, the auditor can check the expenditure on each contract with the cost accounts relating thereto, otherwise he will be unable to verify the item, and will be obliged to accept it upon the certificate of the officials concerned.

The values placed upon work-in-progress should be compared with the latest available architect's, surveyor's or engineer's certificates, and where such comparison reveals that expenditure to date has exceeded the valuation certified, careful consideration should be given to the possibility of an eventual loss on the contract concerned, and the auditor should see that adequate provision has been made for such anticipated losses.

Where cost accounts are kept, the contract ledger for the succeeding period should be examined to see whether any expenditure has been incurred in respect of contracts treated as completed at the end of the previous year, and that if such expenditure has been incurred, provision was made therefor at the date of the Balance Sheet. Careful consideration must be given to the question of liabilities to sub-contractors, and it must be seen where work performed by sub-contractors has been included in certified valuations, that the amount due to the sub-contractors has been included in the value placed upon work-in-progress.

In view of the necessity for wages being paid at various sites, it is essential that the auditor should examine carefully the system of internal check in relation thereto. Wages sheets should be tested exhaustively with workmen's time sheets, insurance cards and P.A.Y.E. tax deduction cards. Each craftsman and labourer in the building trade must also have a holiday-with-pay card and these should be examined, the auditor taking care to see that such cards are stamped up-to-date and that the balance of unused stamps in hand is correct. It should be seen that payments to the workers for holidays have been recovered from the management company dealing with the holidays-with-pay scheme. To reinforce the system of internal check, an occasional visit by the auditor to sites when wages are being paid is desirable, and great care should be taken in examining the records and the system of dealing with "pay offs" at sites.

Under the present day form of building contract, claims by the contractor frequently arise owing to prolongation of the contract by the customer, the impossibility of obtaining essential materials and stores and for other similar reasons. Unless these claims have been settled before the conclusion of the audit, the auditor must satisfy himself that any credit taken therefor in the accounts has been calculated on a conservative basis. In cases where the amount is material and the auditor has doubts as to the final outcome of the claims in question, he should refer thereto in his report to the members.

The question as to whether it is desirable to take profit in respect of uncompleted contracts is important. Where proper cost accounts are kept, it is possible to

ascertain the profit to date by preparing a Profit and Loss Account in respect of each contract, which will be debited with all expenditure on the contract, in the shape of wages and materials, together with a proportionate allowance for indirect expenses, and credited with the proportion of work certified to date. A valuation must then be made of work done, but not yet certified, stores and materials in hand on the contract, and after allowing for depreciation of plant used on the contract, the balance of the account, if in credit, should represent estimated profit to date. Another method, where contracts are nearly completed, is to estimate the cost of completion, and so arrive at the estimated figure of profit to date. Undoubtedly the safest method is not to take any profit until completion; but where profit is taken, the auditor should examine the method by which the estimated figure is arrived at, and see that ample margin is allowed for contingencies, at least one-third of the estimated profit being carried forward, regard being also had to the proportion of cash paid on account. In the case of private firms, the matter is one for the decision of the partners; but in the case of a limited company, the auditor must take care to see that an ample margin for contingencies has been provided, and if necessary he must refer to the matter in his report.

§ 10.—Co-operative Societies.

The auditor should examine the regulations of the society, and ascertain that they are duly carried out.

Shop sales should be vouched with the Daily Sales Summaries, and the total agreed with the Quarterly Summary of sales on which dividends are payable.

The Share Ledgers should be examined, and the capital receipts vouched. Transfers should be tested in respect of dividends not withdrawn, fines, interest, etc. The withdrawals should be vouched, and it should be seen that they are authorised.

The calculations of dividends to members and non-members should be checked in total, and tested in detail. The accounts relating to clothing clubs, penny banks, education fund, building department, etc., should be checked, and the investments and building department mortgages verified.

In addition to the quarterly or periodical certificate in accordance with the rules, the auditor must certify the return sent in annually to the Chief Registrar of Friendly Societies under Section 13 of the Industrial and Provident Societies Act, 1893, as follows :—

> "The undersigned being a public auditor appointed by H. M. Treasury having had access to all the books, documents and accounts of the Society, and having examined the foregoing Annual Return, and verified the same with the books, deeds, documents, accounts and vouchers relating thereto, now signs the same as found to be correct, duly vouched, and in accordance with the law."

§ 11.—Estate Agents, Auctioneers, Surveyors, etc.

Where considerable sums are received on behalf of clients, whether from auctions or otherwise, it is desirable that either a separate clients' banking account should be opened, or that a separate column should be provided in the Cash Book for clients' moneys, in order to avoid any confusion between such moneys and office moneys. Where such a system is not in force, the auditor should check the credit balances shown in the Clients' Ledger, representing moneys in hand on behalf of clients, and ascertain that there is sufficient cash on the general banking account to represent

such moneys, drawing special attention to the fact if this is not the case.

Considerable expenditure is frequently incurred on behalf of clients, both in respect of advertising and otherwise, and it should be seen that there is a proper system in force for passing the invoices relating thereto and charging the expenses to the clients. Similar remarks apply to disbursements incurred through petty cash on behalf of clients. Where sums have been received from clients for the purpose of incurring such expenditure at the date of the Balance Sheet and the whole or part thereof remains unexpended, it should be seen that such balances are carried forward as liabilities.

Where outstanding fees and charges, which have not been debited to the clients, are brought into account, a schedule should be prepared thereof and signed by the partners, but care should be taken to see that no items are included that have not been actually earned, as the majority of the fees and commissions will only be payable in the event of negotiations for selling or letting the properties concerned being successful.

§ 12.—Executors' and Trustees' Accounts.

The auditor should examine the Will and take note of all provisions affecting accounts, particularly the creation of separate trust funds.

In order to ascertain that the whole of the assets left by the testator have been brought into account, the auditor should examine the Estate Duty Account and the Corrective Affidavits (if any).

It should be seen that all apportionments necessary under the Apportionment Act, 1870, or by Case Law, have been properly made.

The whole of the transactions relating to capital must be thoroughly vouched, the purchase and sale of investments by examination of the broker's bought and sold notes, receipts from sales of property by auctioneer's accounts, etc.

In many cases the auditor is presented simply with a Cash Account, and where this is so, it is convenient to prepare a Securities Account in order to ascertain that those securities remaining on hand are all that ought to be accounted for. A good method of doing this is to make a schedule of securities, entering each item at its nominal value on the debit side of the account, and placing on the credit side against each item the reference to any transactions that have taken place in connection with it, extending the nominal amount thereof. When this has been completed, the nominal value of the securities remaining on hand should be represented by the difference between the two sides of the Securities Account.

It should be seen that the investments are duly authorised by the will or are proper trustee investments.

The auditor should vouch the receipt of the whole of the income in the form of interest, dividends, rents, etc., and ascertain that it has been duly paid to the tenants for life.

Frequently the auditor is asked to certify accounts representing the share of a beneficiary on the distribution of an estate, and before doing so he should ascertain that all payments directed by the will, such as debts, legacies, duties, etc., have been paid.

All the securities should be produced at the same time, and their verification forms a most important part of the auditor's duty. Where there are

two or more trustees, and the securities, or some of them, are registered in the name of one of the trustees only, the auditor should report this and suggest that the securities should be in the names of all the trustees.

The rights and duties of an auditor of Trust Accounts appointed under Section 13 of the Public Trustee Act, 1906, have been referred to in Chap. XI, § 6, and the following is a form of certificate which such an auditor is required to append to the accounts examined by him subject to any qualification that may be necessary :—

> "I certify that the above accounts exhibit a true view of the state of the affairs of the   Trust, and that I have had the securities of the trust fund investments produced to me, and that I have verified the same."

For the proper conduct of the audit of Trust Accounts it is necessary to have a considerable knowledge of Trust law, and it is impossible to deal fully with the subject here. The reader may be referred for further information to Ranking, Spicer & Pegler's *Executorship Law and Accounts.*

§ 13.—Foreign Mines.

There are various methods of keeping foreign mine accounts, and in large mines it is customary for complete books and accounts to be kept at the mine. Local auditors are frequently employed in such cases, in which event the company's auditor will not examine the mine accounts in detail, but will confine himself to questions of principle, and to ascertaining that the mine accounts are properly incorporated in the head office books.

Where no local audit is performed, duplicate copies of the mine accounts, duly certified, are usually

sent over each month, and in some cases these are written up into mine books, at the head office, which will be examined by the auditor. In other cases only Cash Accounts are kept at the mine and certified copies sent over. These accounts must be vouched by the auditor in detail, particular attention being given to the payment of wages and to the allocation of expenditure as between capital and revenue. The allocation should be duly certified by the mine manager.

Certified schedules of the debtors and creditors outstanding at the close of the period, stock of ore, stock of materials on hand, etc., should be sent over and examined by the auditor. The proceeds of sale of ore should be vouched by whatever evidence is available, and particular care should be paid to this point where the ore is of a precious nature.

The mine manager should make a report with reference to the treatment of the Development Account, and the condition of the plant and machinery at the mine, and the auditor should examine this in order to form some opinion as to the depreciation or other amounts it may be necessary to write off.

The auditor should check the conversion of the currency accounts into sterling and ascertain the basis adopted. The question of foreign exchange has been referred to in § 3 of this Chapter.

The title deeds of the mine property, or other evidence of title, should be verified by inspection where possible. Where such evidence is abroad and the auditor relies upon the certificates of other parties, the fact should be stated in his report.

§ 14.—**Friendly Societies.**

The regulations of the society should be examined. The Contributions Cash Book and Sick Payments

Register should be checked to the General Cash Book, and the latter checked to the Treasurer's Cash Book. The Members Ledger Account should be examined, particularly with reference to entrance fees, and to seeing that new members are properly charged according to age and benefits acquired. A proportion of the contribution cards or pass books should be examined and tested with the Members Ledger Accounts.

The management expenses should be vouched, and it should be seen that they are properly authorised and that no payments in the nature of benefits are charged to the Management Fund. Any deficit on this fund must be made up by levy on the members of the society.

The various benefit fund accounts should be checked and the balances agreed.

All investments should be verified. A registered society or branch may invest its funds in the Post Office Savings Bank, a Trustee Savings Bank, in public funds or with the National Debt Commissioners, or in the purchase of land, or buildings, or in accordance with the rules of the society.

The accounts must be made up in the form of return prescribed by the Chief Registrar of Friendly Societies.

The following is the form of the auditor's certificate required under Section 26 of the Friendly Societies Act, 1896 :—

"We, the undersigned, having had access to all the books and accounts of the Society, and having examined the foregoing Annual Return and verified the same with the accounts and vouchers relating thereto, now sign the same as found to be correct, duly vouched, and in accordance with law."

§ 15.—Hotels.

The auditor should enquire carefully into the system of accounts utilised, as unless that system is good the opportunities for leakage and manipulation are considerable. The Visitors' Ledger should be examined, and the daily totals vouched into the Summary, and from the Summary into the Impersonal Ledger and Cash Book. It should be seen that items paid out on account of visitors are properly charged up to them, and have been duly collected.

Proper stock accounts should be kept in connection with wines, spirits, cigars, etc., and the auditor should test the operation of these accounts.

The question of the treatment of depreciation of bedding, linen, plate, cutlery, china, etc., is important. It is usual either to revalue these items at the date of each Balance Sheet or to capitalise the original expenditure, and create a provision for Renewals Account, crediting thereto an ample amount according to the experience of previous years, and debiting the actual renewals, the balance being carried forward.

Proper provision should be made for the depreciation of furniture and premises, and where the furniture is on the hire-purchase system, the auditor should ascertain that revenue is duly charged with the interest or hire portion of the instalments paid.

In a large hotel there will be several Petty Cash Accounts, and the auditor should arrange for the balances to be verified simultaneously, in order to prevent manipulation.

§ 16.—Insurance Brokers.

The Premium and Claim Journals should be cast, and the totals of the brokerage and stamp columns

should be checked to the General Ledger. The cross-casts of these journals should also be checked at the end of each period. In the case of the Premium Journal, the total debited to clients must equal the total credited to underwriters and companies, plus the brokerage and stamp totals.

The balances on the Clients' Ledger should be checked, and it should be seen that the accounts are regularly agreed. Similar remarks apply to the Underwriters' Ledger. Owing to the method of calculating premiums in force at Lloyd's, and to the different tables adopted, differences are bound to arise which require to be written off, but the auditor should see that these are not excessive.

§ 17.—Landed Estates.

On the occasion of the first audit, the counterparts of the tenants' leases should be examined to ascertain the rentals and terms, and these should be checked with the Rent Roll.

The Rent Roll should be compared with the Terrier, which is a survey of the estate, in order to ascertain that all the properties comprised are entered on the Rent Roll, except those accounted for as unlet or otherwise.

On subsequent occasions only the counterparts of new leases need be examined.

Rents received should be vouched, and it should be seen that proper authority is forthcoming for deductions or allowances. A schedule of all properties unlet, or those occupied rent free as part of the emoluments or wages of office, or otherwise, should be prepared and submitted to the auditor, certified by the landlord. Arrears should be checked forward

from one period to another, and those outstanding any length of time enquired into.

Receipts from sales of produce, stock, timber, game, etc., should be vouched by reference to the counterfoil receipt books.

§ 18.—Newspapers.

The auditor should vouch the Advertising Day Book with a marked copy of the publication, making enquiry into any dummy advertisements. Amounts received in respect of advertisements not inserted prior to the date of the Balance Sheet should be carried forward in suspense. Similar remarks apply to the vouching and apportionment of periodical subscriptions.

The question of returns in respect of copies unsold is important, and the auditor should see that a proper check is in force relating to this item, and that all returns relating to the period covered by the accounts have been credited to the agents, or provision made for those estimated to be outstanding.

It should be ascertained that all liabilities in respect of contributions have been included. In some cases, where payments are not regularly made, these may be outstanding for a considerable period. The valuation of blocks and electros should be inquired into, as once they have been used these items are normally of little value.

The cost of starting a newspaper is very heavy and involves considerable outlay in the form of advertising, special discounts for pushing sales, etc. Such expenditure in excess of the normal may fairly be charged to an Establishment Account, and carried forward. Another method sometimes adopted is to

charge all expenditure to Profit and Loss, and to transfer the balance of loss in the early years to the Establishment Account; but this principle is somewhat dangerous, as tending to obscure the true result of working, and should certainly be discontinued immediately the paper is fairly established.

If the paper is ultimately successful, and is able to earn an adequate return on the establishment outlay, the latter may be said to represent goodwill, but it is advisable to write it off out of profits over a period of years.

The auditor should examine the Establishment Account, and satisfy himself as to the manner in which it has been dealt with.

§ 19.—Publishers.

The audit of a publisher's accounts will vary according to the nature of the transactions. Many publishers do some, if not the whole, of their own printing, and also carry on a wholesale or retail trade in books other than their own, in addition to actually publishing works. They may also be the proprietors of magazines or reviews. In each instance the questions arising will be those relative to an ordinary trading audit, and need not be referred to here.

Special considerations to which the auditor should direct his attention are the treatment of the value of copyrights, and the amounts taken credit for in respect of the Production or Prime Cost Account of each book.

In most cases a separate Production Account is opened for each book, to which are debited the cost of the copyright (if that has been purchased), together with the prime cost of production such as editing, compiling, indexing, setting up type, illustrations,

blocks, etc. The cost of printing off, paper, and binding, is debited to revenue, and stock is taken into account on the basis of this cost, which is relatively so small that even if the book is a failure the stock value can as a rule be obtained from a remainder bookseller.

An analysis of all sales made should be kept in a Stock Ledger, a separate account being opened for each book, and debited with the total number of copies printed, being credited with the number of presentation copies issued and the number of copies sold, the balance representing the number of copies in stock.

From an examination of this book it will be possible to ascertain at a glance the way in which the sales of each book are progressing, and valuable information will be thereby afforded as to the manner in which the Production Account should be dealt with. Where a second edition is not contemplated, this account should be written down in the proportion that the actual sales bear to the estimated sales, or the whole edition, where it is expected this will be disposed of. Where a second edition is contemplated, moulds of the type are usually taken and stereos prepared therefrom, the cost of these items being debited to the Production Account, which will not then be written down so rapidly.

Where such a system as that above described is not in force, but the whole cost of production and printing is charged to revenue, stock and copyrights being valued accordingly, these should not be valued above cost, and the auditor should see that where the whole edition is not likely to be sold, the value is reduced accordingly.

Where the publisher does not care to incur the risk involved in publishing a book, it is a common

practice for him to accept it at the author's risk, receiving for his services an agreed commission on the sales. In such a case an account will be opened for the book and debited with the total cost by way of production or otherwise. The sales of the book will be analysed from the Sales Day Book, or kept in a separate Day Book, and credited to this account. The commission on sales will be debited, and the balance will then represent the sum due to or by the author, any sums received from the author to cover cost of production having been credited in the first instance. In these cases the question of copyright and stock values does not arise, and care should be taken to see that no stocks of this nature are included in the general stock.

Where books are sent to booksellers on the sale or return principle, it should be seen that the transactions are properly dealt with in accordance with the principles laid down in Chapter III, § 3.

The auditor should ascertain that provision has been made for all outstanding royalties payable to authors. Where advances have been made on account of royalties, and it is found that the sales are not likely to prove sufficient to provide the necessary sum, the balance, by custom of trade, is not repayable by the author, and should be written off or provided for.

§ 20.—Retail Stores.

The duplicates of bills handed to customers should be tested with the abstracts prepared by each salesman, and the abstracts checked into the Departmental Cash Received books, the daily totals of these books being checked into the General Cash Book. Some of the duplicates for credit sales should be

checked with the Sales Journal. Invoices for purchases should be tested, and it should be seen that they are properly allocated to the various departments. The allocation of departmental charges should be checked.

Where the departments are charged with goods at selling price, or at a percentage above cost, as frequently happens where there are branches, the auditor should ascertain that the stocks of such departments are reduced to cost before being incorporated in the final accounts.

§ 21.—Rubber Companies.

The auditor should examine the certified monthly returns sent over from the plantation, and ascertain that expenditure has been properly apportioned as between capital and revenue. In addition to the purchase price of the property the capital expenditure will take the form of payments in respect of buildings; plant and machinery, new clearings, and rubber not in bearing. The general charges at the plantation are usually apportioned between revenue and capital in the ratio that the area producing bears to the area cultivated. The report of the visiting agent, if any, on the apportionment of this expenditure should be examined.

The revenue expenditure will take the form of general charges, upkeep and repairs, cultivation of rubber in bearing, and rubber manufacture.

In most cases the rubber produced is sold on the London market, and the manager's return of shipments should be agreed with the brokers' sale notes, subject to shrinkage in weight. The stock of rubber on hand at the date of the Balance Sheet is usually

brought into account at *sale price*, as it will generally have been sold before the accounts are prepared.

Advances to coolies to be recouped out of their wages during their term of service should be revalued on the occasion of each Balance Sheet, and certified by the manager, as owing to death and other causes the whole of these advances may not be recovered.

Other produce may be cultivated, such as rice, sago, coffee, etc., separate accounts being kept in respect of the expenditure on each class of produce, so that the profit thereon can be ascertained. All expenditure on new crops can be carried forward.

In the event of the title deeds being retained locally, the auditor should obtain a certificate from the company's bankers, or some responsible person, stating that the title deeds are held free from charge.

The auditor should ascertain that the returns are properly incorporated in the head office books, and that the difference on exchange has been correctly adjusted in accordance with the principles laid down in § 3 of this chapter. Items of stock, or cash in transit should be vouched.

Similar considerations apply to the audit of other classes of plantation companies.

§ 22.—Schools, Colleges, and Universities.

The auditor should vouch the fees received with the register of pupils, and ascertain that those outstanding will be duly received, and that all extras have been properly charged up. Any fees paid in advance in respect of a period subsequent to the date of the Balance Sheet should be carried forward.

The capitation fees, paid by house masters for the pupils in their boarding houses, should be vouched.

The charter and regulations (if any) should be examined, and, where endowments exist, the income arising thereunder must be vouched, and the securities verified. Government grants, if any, should be verified.

In the case of universities where the Universities and Colleges Estates Acts, 1858 to 1898, or the Universities of Oxford and Cambridge Acts, 1877 to 1923 apply, the auditor should see that the provisions thereof are duly complied with.

§ 23.—Shipping Companies.

The auditor should examine the Articles of Association, agreements with managing owners, captains, etc.

The original cost of the ships should be vouched, and, in the case of a single ship company, it should be seen that no addition has been made thereto, after the total first cost has been divided into 64 shares. In the case of a shipping company owning a fleet of vessels, only such additions should be made to the cost account as represent proper capital expenditure.

The auditor should examine the bill of sale for each ship, or part of ship, owned, and note that a copy of the entry in the register kept at the Port of Registry is indorsed thereon, or obtain a certificate of registry as to ownership, and mortgages outstanding. A mortgage on a ship is effected by means of a bond, which must be obtained from the Custom House in the prescribed form, for the consent of The Board of Trade, and returned to the Customs at the Port of Registry, where particulars of the bond will be entered against the vessel in the Register of Shipping. The mortgage will be retained by the mortgagee, but its priority dates from the date of production for registry, and not from the date of the instrument.

Voyage accounts are kept in respect of each voyage, and should be vouched by the auditor. It should be seen that each voyage is properly charged with the expenditure on stores. The freight accounts should be vouched with manifests from agents, and advices from receiving offices, and it should be seen that provision is made for outstanding rebates. Passengers' fares, if any, should be vouched, and it should be seen that due allowance is made for return fares outstanding. All outstanding expenses on each voyage account should be provided for before closing the account. The accounts of the home agents and foreign agents should be examined with the vouchers, and it should be seen that foreign exchange is correctly adjusted. The captain's accounts should be examined and vouched in detail, and it should be seen that his remuneration is in accordance with his agreement.

The insurance policies should be examined, and it should be seen that the premiums are properly apportioned over each voyage, and that returns are claimed from the underwriters where ships have been laid up, or for other reasons. Where the policy is a time policy, the proportion unexpired should be carried forward. It should be seen that the amounts received in respect of claims are properly dealt with. Payments to or by protecting clubs for insurance of extraordinary risks should be vouched in a similar manner.

Charter parties should be examined as to brokerage, commissions, and rates of freight, and it should be seen that agreed returns have been credited to each voyage account.

Where a number of ships is owned by the company, the auditor should ascertain that proper depreciation is provided.

In the case of single ship companies, it is not usual to provide any depreciation, but the auditor should refer to this matter in his report to the members so that they may be aware of the position.

In the case of shipping companies owning a fleet of vessels, it is common to find an Insurance Fund in operation, under which the company undertakes the whole or part of the insurance of its vessels. This is effected by debiting to the respective voyage accounts, and crediting to an Insurance Fund Account, premiums at the same rate as would be payable to underwriters, or sometimes at a slightly higher rate, a corresponding amount being invested in outside securities, in order that when claims arise moneys will be forthcoming for the repair or purchase of ships. Any losses will be debited to the Fund Account, and re-insurances where these have been effected, also the cost of administering the fund; the Fund Account, on the other hand, will be credited with interest on the investments by which it is represented, re-insurance refunds, etc.

No profit should be taken in respect of the operation of such an Insurance Fund until it has reached an amount in excess of a reasonable valuation of the risks borne by the company. This valuation should be made under expert advice, and will take into account the number and age of the vessels, the class of trade carried on, and the nature of the voyages. Assuming a profit to have been made, it should not be taken to the credit of Profit and Loss Account, but if it is

desired to distribute it to the shareholders, this should be done by means of a bonus. Some companies, in place of distributing underwriting profits, utilise them for the purpose of acquiring additional ships, and make a corresponding transfer from the Insurance Fund Account to General Reserve.

§ 24.—**Solicitors.**

The auditor must ascertain that the rules of the Council of the Law Society, for the time being in force, relating to dealings with clients' moneys have been complied with.

It is provided by Section 1 of the Solicitors Act, 1933, that the Council of the Law Society shall make rules—

(*a*) As to the opening of and keeping by solicitors of accounts at banks for clients' moneys; and

(*b*) as to the keeping by solicitors of accounts containing particulars and information as to moneys received, held or paid by them, for or on account of their clients; and

(*c*) empowering the Council to take such action as may be necessary to enable them to ascertain whether or not the rules are being complied with.

Section 18 (1) of the Solicitors Act, 1941, provides that the Council of the Law Society shall make rules:—

(*a*) as to the opening and keeping by every solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons of an account at a bank for moneys of any

trust of which he is such a sole trustee or co-trustee;

(*b*) as to the keeping by every solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons of accounts containing particulars and information as to moneys received, held or paid by him for or on account of any trust of which he is such sole trustee or co-trustee; and

(*c*) empowering the Council to take such action as may be necessary to enable them to ascertain whether or not the rules are being compiled with.

If a solicitor fails to comply with any of the rules made under the above sections, any person may make a complaint in respect of that failure to the disciplinary committee.

In the case of a solicitor employed as a public officer the provisions of Section 1 (*a*) and (*b*) and of Section 18 (1) (*a*) and (*b*) do not apply so far as regards moneys received, held or paid by him in the course of his employment as such public officer.

Rules were issued by the Council of the Law Society, and came into force on 1st January, 1935. These rules have now been superseded by the Solicitors' Accounts Rules, 1945, and the Solicitors' Trust Accounts Rules, 1945, which came into operation on 1st January, 1945.

The object of these rules is to make it virtually impossible for a solicitor who complies with them to confuse his clients' money with his own and thus to prevent the recurrence of cases where, without any

original intention to defraud, a solicitor has found himself in financial difficulties through confusion in his accounts.

The rules are as follows :—

SOLICITORS' ACCOUNTS RULES, 1945.

1. These Rules may be cited as the Solicitors' Accounts Rules, **1945**, and shall come into operation on the 1st day of January, 1945, whereupon the Solicitors' Accounts Rules, 1935, as amended on the 2nd day of March, 1939, the 21st day of June, 1940, and the 14th day of May, 1941, shall cease to have effect.

2.—(1) In these Rules, unless the context otherwise requires—

"Solicitor" shall mean a solicitor of the Supreme Court and shall include a firm of solicitors ;

Client" shall mean any person on whose account a solicitor holds or receives client's money ;

"Client's money" shall mean money held or received by a solicitor on account of a person for whom he is acting in relation to the holding or receipt of such money either as a solicitor or, in connection with his practice as a solicitor, as agent, bailee, stakeholder, or in any other capacity ; provided that the expression "client's money" shall not include—

(*a*) money held or received on account of the trustees of a trust of which the solicitor is solicitor-trustee ; or

(*b*) money to which the only person entitled is the solicitor himself or, in the case of a firm of solicitors, one or more of the partners in the firm ;

"Trust money" shall mean money held or received by a solicitor which is not client's money and which is subject to a trust of which the solicitor is a trustee whether or not he is solicitor-trustee of such trust ;

"Client account" shall mean a current or deposit account at a bank in the name of the solicitor in the title of which the word "client" appears ; and

"Solicitor-trustee" shall mean a solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons.

(2) Other expressions in these Rules shall have the meanings assigned to them by the Solicitors Acts, 1932 to 1941.

(3) The Interpretation Act, 1889, shall apply to these Rules in the same manner as it applies to an Act of Parliament, and for the purposes of Section 38 of the said Act the Solicitors' Accounts Rules, 1935, as amended as aforesaid shall be deemed to be an enactment repealed by these Rules.

3. Subject to the provisions of Rule 9 hereof, every solicitor who holds or receives client's money, or money which under Rule 4 hereof he is permitted and elects to pay into a client account, shall without delay pay such money into a client account. Any solicitor may keep one client account or as many such accounts as he thinks fit.

4. There may be paid into a client account—

(*a*) trust money ;

(*b*) such money belonging to the solicitor as may be necessary for the purpose of opening or maintaining the account ;

(*c*) money to replace any sum which may by mistake or accident have been drawn from the account in contravention of sub-rule (2) of Rule 8 of these Rules; and

(*d*) a cheque or draft received by the solicitor which under Rule 5 of these Rules he is entitled to split but which he does not split.

5. Where a solicitor holds or receives a cheque or draft which includes client's money or trust money of one or more trusts—

(*a*) he may where practicable split such cheque or draft and, if he does so, he shall deal with each part thereof as if he had received a separate cheque or draft in respect of that part; or

(*b*) if he does not split the cheque or draft, he shall, if any part thereof consists of client's money, and may in any other case, pay the cheque or draft into a client account.

6. No money other than money which under the foregoing Rules a solicitor is required or permitted to pay into a client account shall be paid into a client account.

7. There may be drawn from a client account—

(*a*) in the case of client's money—

(i) money properly required for a payment to or on behalf of the client;

(ii) money properly required for or towards payment of a debt due to the solicitor from the client or in reimbursement of money expended by the solicitor on behalf of the client;

(iii) money drawn on the client's authority; and

(iv) money properly required for or towards payment of the solicitor's costs where a bill of costs or other written intimation of the amount of the costs incurred has been delivered to the client and the client has been notified that money held for him will be applied towards or in satisfaction of such costs;

(*b*) in the case of trust money—

(i) money properly required for a payment in the execution of the particular trust; and

(ii) money to be transferred to a separate bank account kept solely for the money of the particular trust;

(*c*) such money, not being money to which either paragraph (*a*) or paragraph (*b*) of this rule applies, as may have been paid into the account under paragraph (*b*) or paragraph (*d*) of Rule 4 of these Rules; and

(*d*) money which may by mistake or accident have been paid into the account in contravention of Rule 6 of these Rules:

Provided that in any case under paragraph (*a*) or paragraph (*b*) of this Rule the money so drawn shall not exceed the total of the money held for the time being in such account on account of such client or trust.

8.—(1) No money drawn from a client account under sub-paragraph (ii) or sub-paragraph (iv) of paragraph (*a*), or under paragraph (*c*) or paragraph (*d*) of Rule 7 of these Rules shall be drawn except by—

(*a*) a cheque drawn in favour of the solicitor; or

(*b*) a transfer to a bank account in the name of the solicitor not being a client account.

(2) No money other than money permitted by Rule 7 to be drawn from a client account shall be so drawn unless the Council upon an application made to them by the solicitor specifically authorise in writing its withdrawal.

9.—(1) Notwithstanding the provisions of these Rules, a solicitor shall not be under obligation to pay into a client account client's money held or received by him—

(*a*) which is received by him in the form of cash, and is without delay paid in cash in the ordinary course of business to the client or a third party ; or

(*b*) which is received by him in the form of a cheque or draft which is endorsed over in the ordinary course of business to the client or a third party and is not passed by the solicitor through a bank account ; or

(*c*) which he pays into a separate banking account opened or to be opened in the name of the client or of some person named by the client.

(2) Notwithstanding the provisions of these Rules, a solicitor shall not pay into a client account client's money held or received by him—

(*a*) which the client for his own convenience requests the solicitor to withhold from such account ; or

(*b*) which is received by him for or towards payment of a debt due to the solicitor from the client or in reimbursement of money expended by the solicitor on behalf of the client ; or

(*c*) which is paid to him expressly on account of costs incurred, in respect of which a bill of costs or other written intimation of the amount of the costs has been delivered, or as an agreed fee, or on account of an agreed fee, for business undertaken or to be undertaken.

(3) Where a cheque or draft includes other client's money as well as client's money of the nature described in sub-rule (2) of this Rule such cheque or draft shall be dealt with in accordance with Rule 5 of these Rules.

(4) Notwithstanding the provisions of these Rules the Council may upon an application made to them by a solicitor specifically authorise him in writing to withhold any client's money from a client account.

10.—(1) Every solicitor shall at all times keep properly written up such books and accounts as may be necessary—

(*a*) to show all his dealings with—
  (i) client's money held or received or paid by him ; and
  (ii) any other money dealt with by him through a client account ; and

(*b*) to distinguish such money held, received or paid by him on account of each separate client and to distinguish such money from other money held, received or paid by him on any other account.

(2) Every solicitor shall preserve for at least six years from the date of the last entry therein all books and accounts kept by him under sub-rule (1) of this Rule.

11.—(1) In order to ascertain whether these Rules have been complied with, the Council, acting either—

(*a*) on their own motion ; or

(*b*) on a written statement or request transmitted to them by or on behalf of the Governing Body of a Provincial Law Society or a Committee thereof ; or

(*c*) on a written complaint lodged with them by a third party ;

may require any solicitor to produce at a time and place to be fixed by the Council, his books of account, bank pass books, loose leaf bank statements, statements of account, vouchers and any other necessary documents for the inspection of any person appointed by the Council, and such person shall be directed to prepare for the information of the Council a report on the result of such inspection. Such report may be used as a basis for proceedings under the Solicitors Acts, 1932 to 1941.

(2) Upon being required so to do a solicitor shall produce such books of account, bank pass books, loose leaf bank statements, statements of accounts, vouchers and documents at the time and place fixed.

(3) In any case in which the Governing Body of a Provincial Law Society or a Committee thereof are of opinion that an inspection should be made under this Rule of the books of account, bank pass books, loose leaf bank statements, statements of account, vouchers and any other necessary documents of a solicitor, it shall be the duty of such Governing Body or Committee to transmit to the Council a statement containing all relevant information in their possession and a request that such an inspection be made.

(4) Before instituting an inspection on a written complaint lodged with them by a third party, the Council shall require *prima facie* evidence that a ground of complaint exists, and may require the payment by such party to the Council of a reasonable sum to be fixed by them to cover the costs of the inspection, and the costs of the solicitor against whom the complaint is made. The Council may deal with any sum so paid in such manner as they think fit.

(5) In this Rule the expression "Provincial Law Society" shall mean a Society which is for the time being recognised by the Council as representative of solicitors practising in some part of England or Wales and shall include the City of London Solicitors Company.

12. A written intimation of the amount of a solicitor's costs incurred and a notification to a client that money held for him will be applied as mentioned in sub-paragraph (iv) of paragraph (*a*) of Rule 7 of these Rules may be delivered to a client in the same manner as a bill of costs is required to be delivered under subsection (2) of Section 65 of the Solicitors Act, 1932.

13. Every requirement to be made by the Council of a solicitor under these Rules shall be made in writing under the hand of the Secretary and sent by registered post to the last address of the solicitor appearing in the Roll or in the register kept by the Registrar under subsection (2) of Section 37 of the Solicitors Act, 1932, as amended and re-enacted by Section 7 of the Solicitors Act, 1941, and when so made and sent shall be deemed to have been received by the solicitor within forty-eight hours of the time of posting.

14. Nothing in these Rules shall deprive a solicitor of any recourse or right, whether by way of lien, set-off, counterclaim, charge or otherwise, against moneys standing to the credit of a client account.

SOLICITORS' TRUST ACCOUNTS RULES, 1945.

1. These Rules may be cited as the Solicitors' Trust Accounts Rules, 1945, and shall come into operation on the 1st day of January, 1945.

2.—(1) In these Rules, unless the context otherwise requires—

"Client account" shall mean a current or deposit account at a bank in the title of which the word "client" appears, kept and operated in accordance with the provisions of the Solicitors' Accounts Rules;

"Solicitor-trustee" shall mean a solicitor who is a sole trustee or who is co-trustee only with a partner, clerk or servant of his or with more than one of such persons;

"Trust bank account" shall mean a current or deposit account in the title of which the word "trustee" or "executor" appears kept at a bank in the names of the trustees of the trust and kept solely for money subject to a particular trust of which the solicitor is solicitor-trustee.

(2) Other expressions in these Rules shall have the meanings assigned to them by the Solicitors Acts, 1932 to 1941.

(3) The Interpretation Act, 1889, shall apply to these Rules in the same manner as it applies to an Act of Parliament.

3. Subject to the provisions of Rule 9 of these Rules every solicitor-trustee who holds or receives money subject to a trust of which he is solicitor-trustee, other than money which is paid into a client account as permitted by the Solicitors' Accounts Rules, shall without delay pay such money into the trust bank account of the particular trust.

4. There may be paid into a trust bank account—
(a) money subject to the particular trust;
(b) such money belonging to the solicitor-trustee or to a co-trustee as may be necessary for the purposes of opening or maintaining the account; or
(c) money to replace any sum which may by mistake or accident have been drawn from the account in contravention of Rule 8 of these Rules.

5. Where a solicitor holds or receives a cheque or draft which includes money subject to a trust or trusts of which the solicitor is solicitor-trustee—
(a) he shall where practicable split such cheque or draft and, if he does so, shall deal with each part thereof as if he had received a separate cheque or draft in respect of that part; or
(b) if he does not split the cheque or draft, he may pay it into a client account as permitted by the Solicitors' Accounts Rules.

6. No money, other than money which under the foregoing Rules a solicitor is required or permitted to pay into a trust bank account, shall be paid into a trust bank account.

7. There may be drawn from a trust bank account—
(a) money properly required for a payment in the execution of the particular trust;
(b) money to be transferred to a client account;
(c) such money, not being money subject to the particular trust, as may have been paid into the account under paragraph (b) of Rule 4 of these Rules; or
(d) money which may by mistake or accident have been paid into the account in contravention of Rule 6 of these Rules.

8. No money other than money permitted by Rule 7 of these Rules to be drawn from a trust bank account shall be so drawn unless the Council upon an application made to them by the solicitor expressly authorise in writing its withdrawal.

9. Notwithstanding the provisions of these Rules a solicitor shall not be under obligation to pay into a trust bank account money held or received by him which is subject to a trust of which he is solicitor-trustee and which is received by him either in the form of cash which is without delay paid in cash in the execution of the trust to a third party or in the form of a cheque or draft which is without delay endorsed over in the execution of the trust to a third party and is not passed by the solicitor through a bank account.

10.—(1) Every solicitor-trustee shall at all times keep properly written up such books and accounts as may be necessary—
(a) to show separately all his dealings with money held received or paid by him on account of each trust of which he is solicitor-trustee; and
(b) to distinguish the same from money held received or paid by him on any other account.

(2) Every solicitor-trustee shall preserve for at least six years from the date of the last entry therein all books and accounts kept by him under sub-rule (1) of this Rule.

11.—(1) In order to ascertain whether these Rules have been complied with, the Council, acting either—

(*a*) on their own motion ; or

(*b*) on a written statement or request transmitted to them by or on behalf of the Governing Body of a Provincial Law Society or a Committee thereof ; or

(*c*) on a written complaint lodged with them by a third party

may require any solicitor-trustee to produce at a time and place to be fixed by the Council, all books of account, bank pass books, loose leaf bank statements, statements of account, vouchers, and documents relating to all or any of the trusts of which he is solicitor-trustee for the inspection of any person appointed by the Council, and such person shall be directed to prepare for the information of the Council a report on the result of such inspection. Such report may be used as a basis for proceedings under the Solicitors Acts, 1932 to 1941.

(2) Upon being required so to do a solicitor-trustee shall produce such books of account, bank pass books, loose leaf bank statements, statements of account, vouchers and documents at the time and place fixed.

(3) In any case in which the Governing Body of a Provincial Law Society or a Committee thereof are of opinion that an inspection should be made under this Rule of books of account, bank pass books, loose leaf bank statements, statements of account, vouchers and documents relating to all or any of the trusts of which a solicitor is solicitor-trustee it shall be the duty of such Governing Body or Committee to transmit to the Council a statement containing all relevant information in their possession and a request that such an inspection be made.

(4) Before instituting an inspection on a written complaint lodged with them by a third party, the Council shall require *prima facie* evidence that a ground of complaint exists, and may require the payment by such party to the Council of a reasonable sum to be fixed by them to cover the costs of the inspection, and the costs of the solicitor-trustee against whom the complaint is made. The Council may deal with any sum so paid in such manner as they think fit.

(5) For the purposes of the Rule the expression "Provincial Law Society" means a Society which is for the time being recognised by the Council as representative of solicitors practising in some part of England or Wales and shall include the City of London Solicitors Company.

12. Every requirement to be made by the Council of a solicitor-trustee under these Rules shall be made in writing under the hand of the Secretary and sent by registered post to the last address of the solicitor-trustee appearing in the Roll or in the register kept by the Registrar under subsection (2) of Section 37 of the Solicitors Act, 1932, as amended and re-enacted by Section 7 of the Solicitors Act, 1941, and, when so made and sent, shall be deemed to have been received by the solicitor-trustee within forty-eight hours of the time of posting.

13. Nothing in these Rules shall deprive a solicitor of any recourse or right whether by way of lien, set-off, counter-claim, charge or otherwise, against moneys standing to the credit of a trust bank account.

The following points in connection with the above Rules are stated by the Law Society as matters to be noted :—

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(1) *Signature of cheques.*—Although neither set of Rules specifically so provides, the Council take the view that the signature of cheques on a client bank account by a person other than a solicitor is to be deprecated, and that only in exceptional circumstances should solicitors depart from the practice of signing all cheques on client account themselves.

(2) *A solicitor may not treat himself as a client.*—By virtue of the definition of client's money contained in Rule 2 of the Solicitors' Accounts Rules a solicitor cannot treat himself as his own client for the purposes of the Rules nor can a member of a firm of solicitors be treated as a client of that firm. There was at one time some divergence of practice in this respect, but the present view is that if a solicitor is treated as his own client or as a client of his firm his money is mingled with the money of his clients and the primary object of the Rules is defeated.

(3) *Money received by a solicitor as trustee may be paid into a client bank account.*—Where a solicitor is a trustee of a trust and receives money subject to that trust, he may receive it either in the capacity of solicitor or in the capacity of trustee. To determine forthwith upon receipt in which capacity a solicitor receives such money is in some cases a difficult problem, and to lay down a rule whereby the capacity could be determined would introduce almost insuperable complications into the Rules. Accordingly the Solicitors' Accounts Rules provide that money subject to a trust of which the solicitor is a trustee, whether or not he is a solicitor-trustee in the limited sense used in the Rules, may be dealt with through a client account. Thus, if a solicitor is in any doubt as to the capacity in which he receives money, he may deal with it through his client account and so avoid any question of a breach of the Rules.

(4) *The financing of clients out of the solicitor's own money held in a client bank account is forbidden.*—Some solicitors appear to have believed at one time that they might properly maintain a large floating balance of their own money on client account out of which they might finance clients for whom insufficient money was held. This view has never been correct since 1934, and attention is accordingly directed to Rule 7 of the Solicitors' Accounts Rules, under which no payment can be made to, or on behalf of, a client out of client account in excess of the money held on that account for such client. If a solicitor wishes to advance money to or on behalf of a client he must do so out of his office account. It would be a breach of Rule 7 to do so out of client account.

(5) *A solicitor can only withdraw his own money from a client bank account by a transfer to his office bank account or a cheque in his own favour.*—Provision with regard to the withrawal of money

from client account is contained in Rule 8 of the Solicitors' Accounts Rules. The present form of this Rule is due to the fact that there have been inspections of solicitors' accounts which disclose a practice of making payments in respect of office or personal expenses by cheques drawn on client account against moneys available on that account for withdrawal by the solicitor. It is clear from the information so gained by the Council that this practice led directly to some solicitors becoming confused in their accounts and in some cases withdrawing moneys in excess of the amount available for withdrawal. It was further found on occasion that members of the public or official bodies queried the receipt of cheques drawn on a solicitors' client account in discharge of the solicitor's personal obligations. Rule 8 therefore provides that where money is due to the solicitor from his client account he can only withdraw it by a cheque in his own favour or a transfer to his own or office bank account.

The Council recommend that withdrawals from client account should be only for specific sums which the solicitor is entitled to withdraw from that account, and not of round sums generally on account of costs or other money due to the solicitor.

(6) *A cheque for client's money must be paid into a client bank account, even if it is proposed to draw against it before it is cleared.*—With regard to the payment upon receipt to third parties of client's money, the Solicitors' Accounts Rules provide that where a cheque or draft is endorsed over or cash received is paid to a third party immediately upon receipt in the ordinary course of business, the solicitor is under no obligation to pay the cheque into a client account.

The question has, however, frequently been asked whether a solicitor is entitled to pay a cheque into his client account and to draw against it before it is cleared. The Rules do not contain any exception from the obligation to pay into client account a cheque which it is desired to treat in this manner. The position, therefore, is that where a solicitor receives on account of a client a cheque or draft which he does not endorse over in the ordinary course of business to a third party or the client, he must deal with that cheque through his client account. Ordinarily his bankers will credit the account with the amount of the cheque before it has been cleared and will debit the account if the cheque is not honoured on presentment. The solicitor must therefore use great discretion before drawing against the cheque before it has been cleared and should only do so with the clear understanding that, if the cheque is not in fact met and if the amount drawn from the client account is in excess of the amount held for the particular client, other client's money will have been used to make the payment and he himself will have committed a breach of the Rules.

(7) *Money paid to a solicitor for costs which have been agreed, or costs incurred in respect of which a bill or other intimation of the amount has been delivered, may not be paid into a client bank account.*—In 1941 the Council amended Rules 4 and 5 of the Solicitors' Accounts Rules, 1935, primarily to make it clear that a solicitor was not entitled to pay into his office account or to withdraw from client account money received by him on account of costs, unless those costs had been incurred and a bill or other intimation of the amount had been given to the client. The old Rule enabled a solicitor to pay into a client account money paid expressly on account of costs incurred even if he had delivered a bill or other written intimation to the client. The present Rule 9 (2) (*c*) forbids a solicitor to pay such money into a client account. It is his own money and should not be mingled with the money of his clients. The position, therefore, is that, when a solicitor receives money on account of costs, he must, if the costs have been incurred and an intimation or bill of costs has been delivered, pay it into his office account and not a client account; and, moreover, any payment of or on account of an agreed fee must also be paid into office account. Money received on account of costs in any other circumstances must be paid into a client account.

By Section 1 of the Solicitors Act, 1941, every solicitor in practice is required to deliver to the Law Society every year a certificate signed by an accountant, stating whether the solicitor has complied or not with the above rules.

This section does not apply, however, if the solicitor satisfies the Council that owing to the circumstances of his case the delivery of an accountant's certificate is unnecessary, or that he is a "public officer" who does not take out a practising certificate.

The accountant's certificate has to be delivered once during each practice year (*i.e.*, between the 16th November and the following 15th November, both dates inclusive). The rules governing the certificate, known as the Accountant's Certificate Rules, 1946, which came into operation on 16th November, 1946, are reproduced hereunder.

THE ACCOUNTANT'S CERTIFICATE RULES, 1946.

RULES DATED THE 20TH SEPTEMBER, 1946, MADE BY THE COUNCIL OF THE LAW SOCIETY UNDER SECTION 1 OF THE SOLICITORS ACT, 1941 (4 & 5 GEO 6. CAP. 46), WITH RESPECT TO THE DELIVERY BY SOLICITORS TO THE REGISTRAR OF SOLICITORS OF ACCOUNTANTS' CERTIFICATES.

1. These Rules may be cited as the Accountant's Certificate Rules, 1946, and shall come into operation on the 16th day of November, 1946.

2.—(1) In these Rules the expressions "trust money," "client," "client account" and "client's money" shall have the meanings respectively assigned to them by the Solicitors' Accounts Rules, 1945, but in the case of a solicitor holding one of the offices to which Sections 4, 5, 6 or 7 of the Solicitors Act, 1933, applies, "client's money" shall not extend to money held or received by him in the course of his employment in such office, or to money paid without delay into an account subject to public or official audit.

(2) Other expressions herein shall have the meanings assigned to them by the Solicitors Acts, 1932 to 1941.

(3) The Interpretation Act, 1889, shall apply to these Rules in the same manner as it applies to an Act of Parliament.

3.—(1) An accountant shall be qualified to give an accountant's certificate on behalf of a solicitor if—

(a) he is a Member of

(i) The Institute of Chartered Accountants in England and Wales, or
(ii) The Society of Incorporated Accountants and Auditors, or
(iii) The Association of Certified and Corporate Accountants, or
(iv) The Society of Accountants in Edinburgh, or
(v) The Institute of Accountants and Actuaries in Glasgow, or
(vi) The Society of Accountants in Aberdeen; and

(b) he has neither been at any time during the accounting period, nor subsequently, before giving the certificate, become, a partner, clerk or servant of such solicitor or of any partner of his; and

(c) he is not subject to notice of disqualification under paragraph (2) of this Rule.

(2) In either of the following cases, that is to say, where—

(a) the accountant has been found guilty by the Disciplinary Tribunal of his professional body of professional misconduct or discreditable conduct, or

(b) the Council are satisfied that a solicitor has not complied with the provisions of the Solicitors' Accounts Rules in respect of matters not specified in an accountant's certificate and that the accountant was negligent in giving such certificate, whether or not an application be made for a grant out of the Compensation Fund.

the Council may, at their discretion, at any time notify the accountant concerned that he is not qualified to give an accountant's certificate, and they may give notice of such fact to any solicitor on whose behalf he may have given an accountant's certificate, and after such accountant shall have been so notified, unless and until such notice of disqualification shall have been withdrawn by the Council, he shall not be qualified to give an accountant's certificate. In coming to their decision the Council shall take into consideration any observations or explanations made or given by such accountant or on his behalf by the professional body of which he is a member.

4.—(1) With a view to the signing of an accountant's certificate an accountant shall not be required to do more than—

(a) make a general test examination of the books of account of the solicitor;

(b) ascertain whether a client account is kept;

(c) make a general test examination of the bank pass-books and statements kept in relation to the solicitor's practice;

(d) make a comparison, as at not fewer than two dates selected by the accountant between—

(i) the liabilities of the solicitor to his clients and, if trust money has been paid into the client account under the Solicitors' Trust Accounts Rules, to the *cestuis que trustent*, as shown by his books of account; and

(ii) the balances standing to the credit of the client account; and

(e) ask for such information and explanations as he may require arising out of (a) to (d) above.

(2) If after making the investigation prescribed by paragraph (1) of this Rule, it appears to the accountant that there is evidence that the Solicitors' Accounts Rules have not been complied with, he shall make such further investigation as may be necessary to enable him to sign the accountant's certificate.

5. An accountant's certificate delivered by a solicitor under these Rules shall be in the form set out in the Schedule to these Rules or in a form to the like effect approved by the Council.

6. The Council will in each practice year be satisfied that the delivery of an accountant's certificate is unnecessary, and shall not require evidence of that fact, in the case of any solicitor who—

(1) holds his first current practising certificate; or

(2) after having for twelve months or more ceased to hold a current practising certificate, holds his next current practising certificate; or

(3) holds a current practising certificate after having, in the declaration lodged by him with the Registrar to lead to the issue of that practising certificate, declared that either—

(a) the Solicitors' Accounts Rules did not apply to him because he had not, during the period to which such declaration referred, practised on his own account either alone or in partnership or held or received client's money; or

(b) he was exempt from complying with the Solicitors' Accounts Rules by virtue of holding one of the offices to which Section 4, 5, 6 or 7 of the Solicitors Act, 1933, applies and had not, during the period to which such declaration referred, engaged in private practice; or

(4) has ceased to hold a current practising certificate and, if he has at any time after the 15th day of November, 1945, held or received client's money, has delivered an accountant's certificate covering an accounting period ending on the date upon which he ceased to hold or receive client's money; or

(5) has at no time since the 15th day of November, 1945, held a current practising certificate or held or received client's money.

7. The accounting period specified in an accountant's certificate delivered during the practice year beginning on the 16th day of November, 1946, shall begin on—

(1) the date to which the solicitor's books were last made up before the 16th day of November, 1946; or

(2) if the books were not made up during the practice year beginning on the 16th day of November, 1945, either the 16th day of November, or the day upon which the solicitor first began or began again to hold or receive client's money, whichever be the later;

and shall cover not less than six months or, in the case of a solicitor retiring from practice who has ceased to hold or receive client's money after the 15th day of November, 1945, the period up to the date upon which he so ceased.

8. In any practice year beginning on or after the 16th day of November, 1947—

(1) in the case of a solicitor who—

(a) becomes under an obligation to deliver his first accountant's certificate, or

(b) having been exempt under Rule 6 of these Rules from delivering an accountant's certificate in the preceding practice year, becomes under an obligation to deliver an accountant's certificate.

the accounting period shall begin on the date upon which he first held or received client's money or, after such exemption, began again to hold or receive client's money, and may cover less than twelve months, and shall in all other respects comply with the requirements of subsection (5) of Section 1 of the Solicitors Act, 1941; and

(2) in the case of a solicitor retiring from practice who, having ceased to hold or receive client's money, is under an obligation to deliver his final accountant's certificate, the accounting period shall end on the date upon which he ceased to hold or receive client's money, and may cover less than twelve months, and shall in all other respects comply with the requirements of subsection (5) of Section 1 of the Solicitors Act, 1941.

9.—(1) In any practice year beginning on or after the 16th day of November, 1947, in the case of a solicitor who—

(a) was not exempt under Rule 6 of these Rules from delivering an accountant's certificate in the preceding practice year; and

(b) since the expiry of the accounting period covered by such accountant's certificate has become, or ceased to be, a member of a firm of solicitors;

the accounting period may cover less than twelve months and shall in all other respects comply with the requirements of subsection (5) of Section 1 of the Solicitors Act, 1941.

(2) In the case of a solicitor who has two or more places of business—

(a) separate accounting periods, covered by separate accountants' certificates, may be adopted in respect of each such place of business, provided that the accounting periods comply with the requirements of subsection (5) of Section 1 of the Solicitors Act, 1941, and with these Rules; and

(b) the accountant's certificate or accountants' certificates delivered by him to the Registrar in each practice year shall cover all client's money held or received by him.

10. Every notice to be given by the Council under these Rules to a solicitor shall be in writing under the hand of the Secretary and sent by registered post to the last address of the solicitor appearing in the Roll or in the Register kept by the Registrar under subsection (2) of section 37 of the Solicitors Act, 1932, as amended and re-enacted by Section 7 of the Solicitors Act, 1941, and, when so given and sent, shall be deemed to have been received by the solicitor within forty-eight hours of the time of posting.

11. Every notice to be given by the Council under these Rules to an accountant shall be in writing under the hand of the Secretary and sent by registered post to the address of the accountant shown on an accountant's certificate or appearing in the records of the accountancy body of which the accountant is a member, and, where so given and sent, shall be deemed to have been received by the accountant within forty-eight hours of the time of posting.

12. The Council shall have power to waive in writing any of the provisions of these Rules, other than those of paragraph (2) of Rule 3, in any particular case.

THE SCHEDULE

FORM OF ACCOUNTANT'S CERTIFICATE

1. In compliance with Section 1 of the Solicitors Act, 1941, and the Accountant's Certificate Rules, 1946, made thereunder, I (*a*) , have examined the books, accounts and documents of (*b*) or his firm (*c*) in respect of his practice(s) (*c*) { in partnership under the style of (*d*) / alone under the style of (*d*) } at (*e*) for the accounting period, beginning on the day of 19 , and ending on the day of 19 . (*f*)

2. I certify that from my examination of the books, accounts and documents relating to the above practice(s) produced to me and from the information and explanations given to me I am satisfied that—

(1) during the accounting period the said (*b*) , has complied with the provisions of the Solicitors' Accounts Rules, except so far as concerns

(*g*) certain trivial breaches of the Solicitors' Accounts Rules, due to clerical errors or mistakes in book-keeping, all of which were rectified on discovery. I am satisfied that none of such breaches resulted in any loss to any client;

(*g*) the matters set out on the back hereof; and

(2) (*c*) having retired from active practice as a solicitor, the said (*b*) ceased to hold client's money on the day of 19 . (*h*).

Dated this day of 19 .

(*Signature*). .. . .

TO THE REGISTRAR OF SOLICITORS,
Law Society's Hall,
Chancery Lane, W.C.2.

NOTES.—(*a*) State the full name, firm name (if any), the address and professional qualifications of the accountant.

(*b*) State the full name of the solicitor in respect of whom the certificate is given.

(*c*) Delete as necessary.

(*d*) State the firm name or names of the solicitor.

(*e*) State the business address or addresses of the solicitor to which the certificate refers.

(*f*) The accounting period to be covered by the certificate must comply with subsection (5) of Section 1 of the Solicitors Act, 1941, and with the Accountant's Certificate Rules, 1946.

(*g*) *One or other or both* of the alternative sub-paragraphs marked (*g*) must be deleted. If the second alternative is allowed to stand a detailed note of all breaches of the rules should be endorsed on the certificate.

(*h*) Where clause 2 (2) applies, this date must be the ending date of the accounting period as given at the end of clause 1.

The following extracts from an explanatory memorandum issued by the Council of the Law Society indicate the general nature of the work to be performed by the accountant and the period to be covered.

Nature of the accountant's examination.—It is important to realise that neither the Act nor the Accountant's Certificate Rules require a complete audit of the solicitor's accounts nor do they require the preparation of profit and loss accounts or balance sheets. A complete audit would normally be impracticable in connection with a solicitor's practice, because, for example, it is impossible—or at all events impossible without extreme difficulty—to vouch the payment of stamp duty on original deeds handed to clients. Accordingly provision is made for a test examination—and not a complete audit—of the solicitor's accounts.

The nature of this examination is prescribed by Rule 4 of the Accountant's Certificate Rules. The intention of this provision is that the accountant, when called in to make his examination, should first make a general survey of the books of account and bank statements relating to the solicitor's practice, so that the accountant may satisfy himself that a separate bank account for client's money has been kept, that a reasonable system of book-keeping is in use and that the books are kept up-to-date, and may form a general opinion as to the standard of book-keeping efficiency which obtains. The accountant is not in the normal case required to check and vouch each and every item in the books and bank statements.

The accountant should then select not fewer than two dates at random and make an examination of the solicitor's position regarding liabilities to clients as at each of those dates. He should

ask for such information and explanations as he may require arising out of the general examination and detailed tests. Normally this will be sufficient to enable the accountant to satisfy himself whether or not the solicitor has complied with the Solicitors' Accounts Rules. The question of expense must not be ignored and the Council have no intention of saddling solicitors whose books have been properly kept with the additional costs of a prolonged and detailed investigation by the accountant.

If, however, the general examination and detailed tests disclose evidence that the Rules have not been complied with, the accountant is required to pursue a more detailed investigation.

It is emphasised, however, that normally the general survey of the books and bank statements and the tests to which reference has been made should be sufficient to enable the accountant to give the certificate.

Form of accountant's certificate.—The form of accountant's certificate prescribed in the Schedule to the Accountant's Certificate Rules is such that the certificate will relate to an individual solicitor, whether or not he be a member of a firm of solicitors. Accordingly in the case of a firm where there are several partners the accountant will examine the books of the firm and then render a separate certificate in respect of each partner; each certificate will thus be in substantially the same form, unless there have been changes in the constitution of the firm during the accounting period in question. It will not be sufficient to give a single certificate in respect of the firm.

The accounting period.—The normal accounting period is prescribed by Section 1 (5) of the Solicitors Act, 1941. Such period must begin at the expiry of the last preceding accounting period, cover not less than twelve months, terminate not more than twelve months before the date of the delivery of the certificate to the Registrar, and, where possible, correspond to a period for which the accounts of the solicitor or his firm are ordinarily made up.

Clearly, however, the normal period will not be appropriate in every case. Thus, during the first year after the coming into operation of the Rules special provisions are required because the accounting period cannot begin at the expiration of the last preceding accounting period; these special provisions are contained in Rule 7.

It should perhaps be mentioned here that Rule 9 (2) deals specifically with the case of a solicitor who has two or more places of business. This may occur through the solicitor being a partner in two or more firms, or through the same firm having two or more branch offices where the accounts are kept separately in respect of each. In such a case it may be convenient for the solicitor to deliver separate accountants' certificates—possibly prepared by

different accountants—in respect of each place of business. This course is permissible, but the solicitor must during each practice year deliver accountants' certificates covering all client's money held or received by him.

When a complete audit is undertaken, apart from the requirements of the Solicitors' Account Rules, the auditor should deal with the following matters:—

The system of dealing with petty cash disbursements should be examined, and it should be ascertained that all disbursements made on account of clients are duly charged up to their accounts. In the case of a large office there may be several petty cash accounts, the balances of which should be counted simultaneously.

In checking the Clients' Ledger, allowances to clients should be vouched, and it should be seen that amounts disallowed on taxation are properly adjusted. Where disbursements, such as counsel's fees, have been charged to clients, but have not been paid by the solicitor at the date of the Balance Sheet, it should be seen that the liability therefor is included in the accounts.

Credit balances may be found representing moneys paid by clients on account of costs and disbursements which have not yet been debited. If a payment of this nature is wholly on account of disbursements which have not yet been made, the item will in effect be a liability; but where the whole, or a portion, is in respect of costs which have been earned, but which have not yet been debited to the client, owing to the fact that no bill has been rendered, the ledger account should be adjusted by passing an entry through the Bills Delivered Book for the amount received on account of costs, debiting the clients' account therewith.

In order to ascertain the profit correctly, it is necessary that the undelivered costs should be valued, and a schedule should be prepared from the draft bills of costs. The valuation should be made on a conservative basis, provision being made for allowances, whether voluntary or by taxation. All items which are in any way doubtful should be omitted. This schedule should be signed by the partners.

Many solicitors, however, prefer to leave out of account undelivered costs, not debited to clients. In such cases it is advisable that a note should appear on the Balance Sheet stating that these items are not brought into account.

In the absence of agreement to the contrary, articled clerks' premiums should be apportioned over the term of the articles.

§ 25.—Stockbrokers.

The books of a stockbroker are usually balanced each account, or at least once a month. Where a full audit is carried out, the whole of the postings will be checked, the books cast, and the balances checked on the occasion of each account. Owing, however, to the great amount of detail involved, this course is seldom adopted, and a partial audit may be carried out, the object of which is to test exhaustively the detail work, and to verify the securities.

In checking the balances on the Clients' Ledgers, it should be seen that sufficient cover is held for all debit personal balances of importance. Similar remarks apply to the balances on the partners' accounts representing their private speculative dealings. In checking the balances on the jobbers' ledgers, it should be ascertained that they have been properly

agreed with the jobbers on the occasion of each account, when it is usual to settle for the balance so agreed. Any balances carried forward for a considerable time, without subsequent dealings, should be enquired into, as they may represent items in dispute. In this connection the Splits Account should be examined. This account is often utilised to adjust small differences, and any items of consequence passed through it should be investigated, as it has frequently been utilised to cover petty frauds.

When stock is sold by a broker on behalf of a client, the ultimate purchaser will not be known until the close of the account. On Ticket Day a ticket would be issued by the purchaser of registered stocks, and handed to the jobber from whom the stock was bought. The latter would indorse the ticket with the name of the party from whom he purchased the stock, and deliver the ticket so indorsed to him, this operation being repeated until the ticket reaches the selling broker, differences as between one transaction and another being adjusted between the various parties.

The selling broker would then fill up the transfer deed incorporating the particulars shown on the ticket, and, after having obtained the signature of the seller, deliver the transfer deed, with the stock certificate and the ticket, to the buying broker, receiving payment in exchange.

When received by the selling broker this ticket is termed a "Ticket Receivable." The Ticket Receivable Book should be tested exhaustively by the auditor, who should ascertain that the amount outstanding at the close of each account is subsequently cleared off, and this should be confirmed by reference

to the dates of subsequent delivery as shown in the Transfer Delivery Books.

When registered stock is purchased by a broker on behalf of his client, he himself issues a ticket which is termed a "Ticket Payable." The auditor should test the Tickets Payable Book, and ascertain that the balances outstanding are subsequently cleared off as above indicated.

The General Ledger should be checked entirely, and will contain accounts for commission, interest, and expenses. The commission should be checked from the commission columns of the purchases, sales, and special settlement books, and it should be seen that all half-commissions payable have been duly provided for. The expense accounts should be vouched, and it should be seen that all outstanding liabilities are brought into account.

Commission received on underwriting should be checked with the underwriting book, should one be kept, or with any other evidence available. Stocks of contract stamps should be checked and agreed with the Stamp Accounts. The Dividend Account should be examined and outstanding balances agreed.

The firm's Investment Ledger, representing investments held by the firm, should be checked in detail.

The verification of the securities is the most important and difficult part of the audit. It is sometimes arranged for this to take place several times during the year, without notice being given to the staff of the office. In this way a considerable moral check is exercised. In any event the verification must be performed for the purposes of the annual Balance Sheet. The securities will be of four classes:—

(1) Securities held by the firm as investments, according to the balances in the Investment Ledger.

(2) Securities held as cover against loans made by the broker, or balances due from clients.

(3) Securities awaiting delivery against Tickets Receivable.

(4) Securities held for safe custody on behalf of clients.

The auditor should attend as soon after the close of the account as possible, in order to avoid the numerous adjustments that become necessary if the examination of the securities is delayed, and dealings therein have taken place. The securities should all be produced at the same time, and should be checked off by the auditor with the Security Book or schedules. The Security Book is a memoranda book, which is made up for each account, showing the total amount and value of securities held, the parties on whose account they are held, and to whom they have been pawned, if at all. If not pawned, they will be in what is called the "Box," *i.e.*, either in the strong room of the firm, or in a box deposited with their bankers. This book will not contain particulars of the securities held for safe custody on behalf of clients, which should be recorded in a separate book. Columns should be provided for the name of the client, the name of the stock, the making-up price, the value, the amount of the client's balance against which the stock is held, and note should be made whether the stock is in the box, or has been pawned. It must be seen that there is sufficient margin where stock is held as security, the making-up prices and calculations being checked for this purpose, and the clients' balances

being compared with the ledger accounts. Care must be taken to see that all securities held according to the books are contained in these schedules, and certificates must be obtained from all banks and other parties, to whom stocks have been pawned as cover for loans, stating the amount of the loan and the various stocks held. These certificates will be checked off, and will serve to verify the existence of the stocks mentioned in them. All remaining stocks should be in hand, and be examined by the auditor, the usual precautions being taken to prevent stocks being produced twice over.

Securities held for safe custody on behalf of clients will not appear in the books from the point of view of double entry. A special memorandum book should be kept to record these securities, but in many cases it is found very difficult to do this, and they are included in the general memoranda books referred to above. In any case, it is impossible for the auditor to prove that all securities held for safe custody are produced to him, and he should be careful to refer to this point in his report.

§ 26.—Stockjobbers.

The accounts of a stockjobber or dealer, although in many respects similar to those of a broker, differ in some important essentials. The business of a jobber or dealer is to buy and sell as principal, whereas a broker merely buys and sells, as agent for his client, from or to the dealer. Consequently the profit of a broker is obtained from the commission charged by him for his services, whereas the profit of a dealer is derived from selling stock at a higher price than he gave for it, or buying stock at a lower price than that for which he has previously sold it.

The Stock Journals record the dealings in each particular stock for each account, and columns are provided for the quantities of stock dealt in as well as the money values. If the opening balance is a debit, it represents stock in the box at the commencement of the account; if a credit, it is termed "Name-over" or "Box-short," and represents stock which has been over-sold and cannot be delivered. Where the jobber has purchased more stock than he has sold, he is a "Bull" for the balance he holds; where he has sold more stock than he has purchased, he is a "Bear" for the balance. At the close of each account the balance of the quantity columns, whether bull or bear, is inserted at the making-up price, or otherwise, as the case may be, and this should agree the stock quantity columns. The money columns, however, will not usually agree, and the difference will represent profit or loss on the dealings during the account, which should be transferred to a Profit and Loss Book.

The auditor should check the opening and closing balances, both quantity and value. Postings from the Cash Book for application and allotment moneys on stocks applied for, underwriting commission, etc., should be checked to the various accounts; the postings from the jobbers' or brokers' ledgers should be tested; the stock columns cast and agreed, and the profits and losses checked to the Profit and Loss Book. Joint books are frequently kept with other jobbers, the profits or losses being divided by mutual agreement, and the auditor should see that the necessary transfers have been made.

The balances on the Stock Journals should be agreed with the "Bull and Bear" books kept by

the partners or their authorised clerks, which are memoranda books recording the dealings from day to day of each stock in quantities and prices only. The auditor should examine these books and ascertain that the bull or bear agrees with the Stock Journals both as to quantity and price, the price being usually marked by the partners for Balance Sheet purposes in the Bull and Bear books. The auditor should also check the calculations of the values of the stocks, as any error in extending the values affects directly the profit or loss.

The Dividend Journal records the dividends receivable or payable. The auditor should ascertain when the various stocks become quoted *ex div.* If the jobber is bull of the stock at that date, the dividend thereon should be ultimately received; if he is bear of the stock, the dividend in respect thereof will be payable by him. If the stock is "even," any dividends received will be payable to other persons, and should be treated as a liability, if not paid over at the date of the Balance Sheet.

The verification of the securities should be carried out in a similar manner to that described in the case of stockbrokers, but the securities to be examined will be all of one nature, namely, those recorded as box balances in the Stock Journals. The schedule of these should, therefore, be checked with the journals as to quantities and verified in the usual manner, certificates being obtained from bankers and others where securities have been pawned for advances. In the case of registered securities, the evidence will take the form of certificates, balance certificates, transfers, transfer receipts, etc., and great care must be exercised by the auditor to ascertain that the total

balance of each stock held is duly vouched in one form or another in accordance with the principles set out in Chapter V, § 3.

Other points common to the accounts of jobbers and brokers have been dealt with in the preceding section.

§ 27.—Theatres and Cinemas.

The receipts of a theatre to a large extent take the form of coin and notes, and the auditor should ascertain that the system of recording the receipts is satisfactory, and that all takings are paid into the bank at least once every day.

The daily returns from each Box Office should be signed by the box office official concerned, and entered daily on a final return which should be certified by the treasurer. The final returns should be vouched on to the weekly summaries of income and expenditure, which are usually termed Balance Sheets.

The libraries and agents usually settle for seats weekly, and these receipts should be vouched with their returns, which will also disclose any amounts outstanding at the date of the Balance Sheet.

In the case of a cinema the numbers of the tickets issued are automatically recorded on a "clock," and the takings can be tested by reference to the number of tickets at each price registered on the clock as having been issued.

Receipts from the sale of programmes should be vouched to the weekly Balance Sheets from the Programme Book, the amounts being entered after deducting the commission payable to the sellers. Similar remarks apply to vouching receipts from the sale of sweets, with the Sweets or Chocolate Book.

Receipts from the hire of opera glasses should be vouched with the Opera Glass Book, except in cases where the glasses do not belong to the theatre, but are furnished by contract, when the contract will be examined.

Receipts from advertising on programmes or on the curtain will be vouched with the Advertisement Book and contracts. It should be seen that a proper check is in force relating to the bar receipts. It is usual to charge each bar with supplies at selling price to enable the stock to be checked. The daily summary of takings in each bar should be vouched on to the final daily return, which will be vouched to the weekly Balance Sheet.

A daily summary of the various final returns should be made, representing the amount paid into the bank, and the auditor should examine these with the pass book, care being taken to see that the dates correspond. Cases have been known where the takings have been regularly manipulated, so as to permit of one or two days' takings being nominally in hand whereas actually they have been misappropriated.

It should be seen that the amounts charged in respect of Cost of Production, or Mounting Account, only represent the actual expenditure on the scenery and dresses, though no objection can be taken to the allocation to this account of salaries, lighting, and other expenses incident to rehearsals. The auditor should ascertain that the amount for which credit is taken in the Balance Sheet in respect of this account is not excessive, having regard to the life of the play concerned, and its prospective earning power.

The system adopted for preparing and paying wages should be examined. The wages are usually

divided between "front" and "back," the former relating to persons employed in the front of the house, such as box office officials, programme sellers, attendants, etc., while the latter relates to persons employed behind the stage, such as carpenters, scene shifters, mechanicians, etc. The artists' salary list should be vouched with the contracts with each individual artist.

In the case of a cinema, the cost of the films rented, which is frequently based on a percentage of the takings, can be vouched by reference to the renter's invoices and the returns of takings.

The expenditure on advertising is a heavy item, and should be vouched with the contracts.

Receipts in respect of touring companies should be vouched with the certified returns, submitted by the managers of the theatres visited, the percentage of the receipts payable to the touring company being vouched with the contract. Travelling expenses should be vouched with the touring manager's certified schedule, and cartage on scenery with the vouchers.

§ 28.—Trust and Finance Companies.

The purchase and sale of investments should be vouched by inspection of brokers' contract notes, and where transactions are carried through *cum* or *ex* dividend, it should be seen that proper apportionments have been made. It should be ascertained that all dividends and interest receivable have been received. Securities should be verified in the usual manner, and the book value should be compared with the market value at the date of the Balance Sheet. It is not usual to adjust the value of each investment to market price, but to provide, if necessary, for the difference between the total book value and the market value.

Where shares are not fully paid, the contingent liability in respect of calls not yet made should be stated on the Balance Sheet; but where calls have actually been made, which have not been paid by the company, the amount should be treated as an actual liability.

The correct treatment of profits and losses made on the sale of investments and the depreciation, if any, in the value of investments at the date of the Balance Sheet, will depend upon the exact nature of the company.

In the case of a trust company proper, it has been held that the investments are fixed assets, and that, subject to the Articles, the excess of current income over current expenditure can be divided without making good depreciation on the investments (*Verner* v. *General and Commercial Investment Trust, Ltd.*, 1894, 2 Ch. 266). This decision has been discussed at length in Chapter VIII, § 2. Losses on investments sold by such companies, therefore, need not, legally, be charged to revenue before arriving at profits available for dividend, but similarly profits made must be treated as capital profits. Each case must, however, be determined by the provisions of the company's Memorandum and Articles. Where depreciation or losses have not been provided for, the auditor must see that the Balance Sheet describes clearly the true position, and, where necessary, he should refer to the matter in his report to the members.

In the case of a finance company, whose primary object is not to hold investments for the purpose of earning income, but to buy and sell them at a profit, the investments so held cannot be regarded as fixed assets. They are, in effect, the equivalent of stock-in-trade and must be treated as floating assets,

and brought into account at their value as at the date of the Balance Sheet. Losses made on the sale of investments must be charged to revenue, or to any Provision for Depreciation of Investments Account that may exist, and profits may be taken to the credit of revenue.

It is frequently a matter of great difficulty to arrive at a proper value to be placed on speculative shares, particularly where they are held in companies which have been promoted by the finance company. The only sound system to adopt is to treat such shares on a cost basis, making the necessary provision if they have depreciated below cost. It is not always possible to rely on market quotations in the case of newly-promoted companies, since such quotations are frequently merely nominal, and do not represent actual value.

Where promotion profits have been received in fully-paid shares, these should not be brought into account at their nominal value. If there is a cash profit on the promotion, apart from the shares, the latter should remain unvalued until realised, when the amount so realised can then be treated as profit. If, on the other hand, there is a cash loss on the Promotion Account, this can be regarded as the cost of the shares acquired, which can be brought into account at this figure, subject to depreciation.

Where underwriting transactions have been entered into, and the finance company has been obliged to take up shares, the underwriting commission received should be set against the cost of the shares so taken up, and not treated as profit.

Generally speaking, it may be said that the safest method is that the Profit and Loss Account should

only be credited with actually realised profits. Where the accounts are not prepared in this manner, but credit is taken for profit represented by shares unsold, the auditor should deal fully with the matter in his report to the members. In some cases a separate Profit and Loss Account is compiled, showing the share profits, and this method is convenient where scrip dividends are declared payable in the shares of other companies.

The auditor should ascertain what, if any, transactions are open on the Stock Exchange at the date of the Balance Sheet, since shares may have been purchased but not taken up, or sold but not delivered. In either event the contingent liability might be considerable. Where the transactions have been closed subsequent to the Balance Sheet, and the result is a loss, this should be provided for; but no credit should be taken for profit. Where, however, the transactions remain open at the date of the audit, a note should appear upon the face of the Balance Sheet, stating that there are contingent liabilities in respect of transactions open on the Stock Exchange, and if the auditor considers the matter important, he should deal with it in his report to the members.

All transactions with allied companies should be carefully examined, and it should be seen that no manipulations are effected for the purpose of "window-dressing" the respective Balance Sheets.

§ 29.—Trustee Savings Banks.

The auditor should ascertain that the totals of the subsidiary cash books are correctly entered into the general cash book. The bank balance should be verified, and the cash in hand counted.

The postings from the Cash Book to the Depositors' Ledgers should be tested, and also the calculations of interest credited to depositors. The auditor should examine some of the Depositors' Pass-books with the Depositors' Ledgers, not accepting those offered by the officials. This examination should be more or less continuous throughout the year, so that not less than 10 per cent. of the pass-books are examined in the course of the year. The Balance Book should be checked with the Depositors' Ledgers, and it should be seen that the total thereof agrees with the balance of the Depositors' Account in the General Ledger. This Balance Book is open for the inspection of all depositors, and contains no names, but each depositor has a number attributed to him. The auditor is required to certify that he has examined this list.

The National Debt Commissioners' Account should be examined for the purchases and sales of stocks, transfers, interests, etc.

§ 30.—Underwriters at Lloyd's.

In order to comply with the requirements of the Assurance Act, 1909, all underwriters at Lloyd's are required to have their accounts audited by a professional accountant approved by the Committee of Lloyd's, who must give an audit certificate in the form required by the Committee, which must be sent in duplicate to the Committee before the 15th of March in each year. Only those members who have passed the audit to the satisfaction of the Committee are posted at Lloyd's.

The Committee of Lloyd's issues each year instructions for the guidance of auditors, which

indicate the work to be undertaken and the basis upon which the outstanding liability on the underwriters' accounts is to be ascertained.

These instructions are of a detailed character and are subject to amendment from year to year. They are only issued to auditors on the panel approved by the committee, and it is therefore not possible to detail them here, nor is it desirable to attempt to summarise the main points involved.

It may be said, however, that apart from the actual verification of the assets and liabilities shown in the books, the main object of the audit is to compute the outstanding liability of each underwriting member, and to ascertain that there is a surplus of assets sufficient to wind up the underwriting account on the basis laid down by Lloyd's Committee.

§ 31.—Unit Trusts.

The Board of Trade has issued the following regulations under the Prevention of Fraud (Investments) Act (which came into force in August, 1944) relating to the accounts and audit of Unit Trusts.

Audit.—The trust deed should provide for audit by accountants approved by the trustees of all accounts before circularisation and for a certificate of audit to be appended to the accounts circulated. The audit certificate should declare that the accounts and statements attached thereto have been examined with the books and records of the trust and of the management company, in relation thereto, and that the auditors have obtained all the information and explanation they have required. The auditors should report whether the accounts are, in their opinion, properly drawn up in accordance with such books and records to disclose the profits or losses accruing to the managers from the trust.

Accounts.—The trust deed should provide for the circulation of accounts to unit holders, not less frequently than once a year (but not more than six months after the end of the period to which they relate). Attached to these accounts there must be a statement certified by the auditor showing the amount and percentage gross profits (before any deductions) or losses made (1) from the sale of new units; (2) from the resale of units; and (3) from the sale of the underlying securities of liquidated units.

If in the aggregate the holding of securities before appropriation or after liquidation of units and the holding of units results in a loss the manager shall disclose such loss in each of the above statements. The manager may disclose any holding profit if he so desires.

The percentage of profit or loss from the sale of new units should be calculated on the proceeds in the period of the account of the sale of new units. The percentage profit or loss from the resale of units should be calculated on the proceeds in the period of the account of the resale of units, and the percentage profit or loss from the sale of underlying securities of liquidated units should be calculated on the proceeds in the period of the account of such sales. (The cost of the securities to the manager should be regarded as the price allowed in the purchase of the relevant unit.)

Note.—Holding profits or losses shall be deemed to be profits or losses resulting from price variations of (*a*) units between the dates of creation or purchase and sale; (*b*) underlying securities between the time of purchase and appropriation and between the time of liquidation of units and sale of the underlying securities.

Capital and Income Distributions.—The trust deed should also provide that as at the end of each distribution period there should be circulated two statements certified by the auditors. The first should show what percentage of the total value of the trust funds was at the end of the distribution period invested in each investment and the percentage represented by cash (other than cash to be distributed for that period), and appended to these statements there should be quoted the bid price of units (ex dividend) on the last day of the distribution period.

The second statement should show how the amounts distributed to unit holders are made up, setting out in respect of each distribution and related to some convenient number of units, the gross amount of all cash dividends, interest, income bonuses, etc., the amount of income-tax deducted therefrom, the amount of any cash of a capital nature which is distributed and its source and the amount of all deductions, whether by way of annual or semi-annual charge from income or capital, together with an indication of the provisions in the trust deed which authorise such deductions and state separately the amount included in respect of any dividends accrued before the purchase or vesting of the relevant securities. The statement in respect of capital distributions should be kept distinct from that in respect of income distributions.

Directors' Certificate.—The trust deed should provide that the accounts shall be accompanied by a certificate signed by the directors of the management company, stating whether the company has or has not—

(i) transferred units to another person for sale, resale, liquidation, or subsequent transfer to the management company, for sale, resale or liquidation; or

(ii) acquired or disposed of underlying securities otherwise than through recognised Stock Exchange; or

(iii) disposed of units to another person for a price lower than the current offered price; or

(iv) acquired units for a price higher than the current bid price, and if so, to what extent in each case.

The directors may append any explanation they deem desirable.

CHAPTER XIII

THE AUDIT OF ACCOUNTS OF LOCAL AUTHORITIES

§ 1.—The Classification of Auditors of Local Authorities.

There are three recognised systems of audit for the accounts of local authorities in England and Wales, *viz.*—

(1) Borough audit conducted by two elective auditors and one Mayor's auditor under the provisions of Sections 237 and 238 of the Local Government Act, 1933.

(2) Professional audit performed by professional accountants in accordance with the provisions of Section 239 of the Local Government Act, 1933.

(3) District audit conducted by district auditors appointed by the Minister of Health and paid by the Treasury from monies provided by Parliament which are recovered from the local authorities, whose accounts are audited, by means of a stamp duty, which is based on the total of the expenditure which is audited. The relevant statutory provisions are contained in Sections 218-236 of the Local Government Act, 1933.

§ 2.—Borough Audit.

Borough auditors are three in number, two, called elective auditors, being elected by the local government electors for the borough, and one, who is

appointed by the Mayor, called the Mayor's auditor. An elective auditor must be qualified to be a councillor, but must not be a member or officer of the council. The Mayor's auditor, on the other hand, must be a councillor.

The provisions relating to a borough audit apply only in the case of county boroughs and non-county boroughs and even then, certain accounts of those boroughs, must be submitted to the district auditor. The appointment is, in each case, for one year, but the retiring auditors may be re-elected to the office at the end of each year.

The system of elective audit has been severely criticised in the courts. There is no provision for the borough auditors to make a report or issue a certificate on the completion of their audit, but it is usual for such auditors to sign a certificate in a simple form. In practice, the borough auditors usually confine themselves to an examination of the cash book with the relevant vouchers, together with a perusal of a bank reconciliation statement.

§ 3.—Professional Audit.

Professional auditors are only appointed in municipal boroughs, and then in pursuance of a resolution passed in accordance with the provisions of Section 239 of the Act of 1933. A resolution of adoption must be passed by a majority consisting of not less than two-thirds of the members of the Council present and voting at a meeting specially called for the purpose, of which not less than one month's previous notice of the object of the meeting has been given to every member of the Council, and which must be confirmed by the Council at a regular meeting held

not less than one month after the passing of the resolution.

When a professional audit has been adopted, the council cannot revert to a system of borough audit, as Sections 237 and 238 of the Act will cease to have effect.

If the professional audit is adopted, the district audit will continue to be applied to accounts such as education, rate collection, housing, police and other services in respect of which exchequer contributions are received. Section 239 (3) of the Act contains the following provisions, which apply to the audit by professional auditors :—

(*a*) An auditor or auditors shall be appointed in writing under the seal of the Council for such period and upon such terms as to remuneration or otherwise as the Council of the borough thinks fit.

(*b*) No person shall be qualified to be so appointed unless he is a member of one or more of the following bodies, *viz* :—

The Institute of Chartered Accountants in England and Wales.

The Society of Incorporated Accountants and Auditors.

The Society of Accountants in Edinburgh.

The Institute of Accountants and Actuaries in Glasgow.

The Society of Accountants in Aberdeen.

The Association of Certified and Corporate Accountants.

(*c*) Any auditor so appointed shall be entitled to require from any officer of the borough such

books, deeds, contracts, accounts, vouchers, receipts and other documents, and such information and explanations as may be necessary for the performance of his duties.

(*d*) Any auditor so appointed shall include in, or annex to, any certificate given by him with respect to the accounts audited by him such observations and recommendations (if any) as he thinks necessary or expedient to make with respect to the accounts or any matter arising thereout or in connection therewith.

The duties of a professional auditor are not otherwise defined and they do not have the powers of disallowance and surcharge. It will be appreciated that these powers are necessary in order to make an audit an effective protection. There are no specific statutory powers which would enable the auditor to criticise the actions of the council in relation to the making and collection of rates, etc., similar to those which are contained in Section 228 (2) of the Local Government Act, 1933, which applies to district auditors. The work of professional auditors is, to a large extent, based upon the contract of appointment, but it may be assumed to include the following matters :—

(1) The certification of the Balance Sheets of the borough council after due verification of the several items shown therein.

(2) An examination of the Revenue Accounts, in order to ascertain that all the income of the Council has been brought into account and that all expenditure is duly vouched and is in accordance with the law.

(3) A report to the Finance Committee of the Council drawing attention to any particular points in accountancy practice which it is considered to be necessary to report upon.

In addition, the professional accountant would, no doubt, give the Council the benefit of his varied experience by way of suggestions for the improvement of systems of accounts and the possibility of adopting modern methods of accountancy. It is advisable that the professional auditor, when entering into the contract of service with the Council, should have his duties and responsibilities clearly defined, and the existence or otherwise of a good system of internal check and internal audit will make a considerable difference to the quantity of detailed work which he would be called upon to audit.

§ 4.—District Audit.

The district auditor, appointed by the Minister of Health under the provisions of Section 219 of the Local Government Act, 1933, is responsible for the audit of the accounts of the following local authorities :—

(*a*) The accounts of every county council, metropolitan borough council, urban district council, rural district council, and parish council, and of every parish meeting for a rural parish not having a parish council.

(*b*) The accounts of any committee appointed by such council or parish meeting.

(*c*) The accounts of certain joint committees where the accounts of one or more of the constituent authorities are wholly subject to district audit.

(*d*) Any other accounts which are made subject to audit by a district auditor by virtue of any enactment or statutory instrument or in the case of the accounts of the council of a borough, in pursuance of a resolution adopting the system of district audit passed by the council in accordance with the provisions of the Act.

It will be observed that except where the resolution mentioned in (*d*) above is passed under Section 239 (1) of the Act of 1933, the accounts of municipal boroughs are not subject to district audit. There are, however, certain special accounts of a borough council which are subject to district audit by enactment or statutory instrument, including the accounts for education services, rate collection, housing schemes, police and other services in respect of which exchequer contributions are received.

Local health authorities (county councils and county borough councils) are required to keep separate accounts of income and expenditure on health services, and those accounts have to be made up and audited in like manner to the accounts of a county council, *viz.*, by district auditors.

Section 239 of the Act of 1933 empowers a borough council to adopt the system of district audit for the whole of their accounts as an alternative to professional audit.

§ 5.—Regulations applying to District Audit.

The district audit is governed by and applied as laid down in the provisions contained in the Local Government Act, 1933, and in certain statutory rules and orders and statutory instruments, the more important of which are described below.

Local Government Act, 1933—*Sections* 219-236.

(*a*) The Minister of Health may appoint such number of district auditors as he considers necessary and assign to them their duties and districts.

(*b*) Salaries and expenses of district auditors are paid by the Treasury, and local authorities are charged by way of stamp duty according to a scale fixed by the Treasury. The charge may be reduced on application of the local authority if the scale charge exceeds the cost of the audit.

(*c*) The local authority must prepare and submit a prescribed form of financial statement to the district auditor in duplicate; one copy is stamped and certified by the auditor, and sent by him to the Ministry of Health.

(*d*) Accounts are to be made up yearly to the 31st March or to such other date as the Minister of Health may direct.

(*e*) The accounts made up and balanced must be deposited in the appropriate office of the authority and be open for inspection by any person interested for 7 clear days before the audit.

(*f*) The auditors may require the production of all books, vouchers and documents.

(*g*) Any local government elector for the area may make objection to the accounts before the auditor.

(*h*) The auditor, within 14 days after the completion of the audit, must report to the local authority.

(*i*) The auditor must disallow any item of account contrary to law and surcharge the same upon the person responsible for incurring or authorising the expenditure. If any such expenses have been specially sanctioned by the Minister of Health, the auditor has no power to disallow them.

(*j*) An appeal against the auditor's decision as to surcharge lies to the High Court alone where the amount exceeds £500, and if less than that sum, to the High Court or the Minister of Health, as the applicant may desire. A person surcharged may apply to the High Court or the Minister for a declaration that he acted reasonably or in the belief that his action was authorised by law; if such a declaration is made, the Court or Minister may relieve either wholly or partly from personal liability in respect of the surcharge.

(*k*) Any sum due in respect of a surcharge, unless there is an appeal, must be paid within 14 days after the auditor has certified the same. If it is not paid, the amount is recoverable either summarily or otherwise as a civil debt.

(*l*) The Minister of Health may at any time direct the auditor to hold an extraordinary audit of any accounts which are subject to district audit.

Regulations have been made from time to time by the Minister of Health with respect to preparation and audit of accounts which are subject to audit by a district auditor, including the financial transactions which are to be recorded in the accounts; the mode of keeping the accounts of the authority and form of those

accounts; the mode in which, if it is so prescribed, the accounts are to be certified by the authority or any officer of the authority; the publication of the time and place of holding the audit; the persons by whom the accounts are to be produced at audit; the mode of conducting the audit; the form of certificates to be given by the district auditors; the deposit and inspection of the accounts as audited; and the publication of information with respect thereto and the making of an abstract of the accounts.

The regulations have to be laid before each House of Parliament as soon as possible and if any person wilfully neglects or disobeys any regulation, he shall be liable on summary conviction for a first offence to a fine not exceeding £5, and for a second or subsequent offence, to a fine not exceeding £20. The Minister of Health has no power to make regulations with regard to the accounts of a local authority which are not subject to district audit.

The important statutory rules and orders and statutory instruments which apply to district audit at the present time are as follows:—

(1) *The General Accounts Order, 22nd March,* 1880.

This order contains regulations fixing the date when accounts are to be closed and the books which have to be kept by the clerk to a local authority; the records to be kept by the surveyor; the accounts to be kept by the collectors and other officers; the production of books to the auditor; the general outline of the work to be performed by the auditor; the form of an accountant's certificate and the form of the financial statement. This order is accompanied by a memorandum of instructions giving in detail the items to be entered under the various heads of

(2) *London (Rate Collection) Accounts Order*, 1901.

This order, as amended, contains regulations applying to the accounts relating to the making, levy and collection of any rate made by the council of any metropolitan borough, and the form of demand note to be used for such rate. The amending order prescribes the form of demand note to be used by rating authorities in London consequent upon the passing of the Local Government Act, 1929.

(3) *Accounts (Payment into Bank) Order*, 1922.

This order operated from 1st April, 1923, and prescribed:

(*a*) That where money is received by an officer of a local authority for payment by him into a banking account of the local authority or of their treasurer, the local authority shall secure that a paying-in book is provided for the use of the officer.

(*b*) Every paying-in book shall contain a number of paying-in slips for the entry of money paid into the bank, together with a counterfoil or duplicate of each paying-in slip.

(*c*) Every officer who pays money into a banking account of a local authority or of their treasurer shall, unless the local authority otherwise directs, enter on a paying-in slip and on the counterfoil or duplicate thereof, particulars of such payments, including in the case of each cheque paid in—

(i) the amount of such cheque;

(ii) some reference (such as the number of the receipt given or name of the debtor) which

will connect the cheque with the debt or debts so discharged or partially discharged for which it is presented ;

(iii) where any cheque paid in was not received in discharge of a debt due to the local authority, the officer shall note the fact on the counterfoil or duplicate of the paying-in slip.

(*d*) Any officer of a local authority by whom a paying-in book is kept shall produce the book for examination as and when required by the local authority or at district audit.

(*e*) Where a portion only of the accounts of a local authority is subject to audit by a district auditor, the above regulations shall apply to the local authority and their officers in relation to that portion of those accounts.

(4) *The Rate Accounts* (*Boroughs and Urban District Councils*) *Order*, 1926.

This order came into operation on the 1st April, 1927, and prescribes the books, forms and accounts which are to be kept by the borough and urban district councils acting as rating authorities. The order also sets out the duties of certain officers concerned with the accounts. The Minister retains the power to assent to departures from the order in any case where this appears to be necessary. The order also deals with expenses of collection and valuation expenses, and by the provisions of Section 54 of the Rating and Valuation Act, 1925, these accounts are to be audited by the district auditor.

(5) *The Rate Accounts (Rural District Councils) Order,* 1926.

This order came into operation on the 1st April, 1927, and prescribes the books, forms and accounts which are to be kept by rural district councils acting as rating authorities under the Rating and Valuation Acts, 1925-1932. The order also sets out the duties of certain officers concerned with the accounts, and any departure from the order must be approved by the Minister of Health.

(6) *Assessment Committees (Financial Statement and Audit of Accounts) Order,* 1927.

This order applies to the accounts of Assessment Committees constituted under the Rating and Valuation Act, 1925, and prescribes the form of financial statement to be submitted in duplicate to the district auditor.

(7) *Accounts (Boroughs and Metropolitan Boroughs) Regulations,* 1930.

This order operated from the 1st April, 1930, and deals with the accounts to be kept by town councils and metropolitan borough councils, together with county borough councils, so far as they are subject to district audit. The regulations define the principles upon which the accounts are to be kept and the results which are to be attained. The form and method of the book-keeping applicable to the chief accounts of the council is defined, but the forms of primary records, statements and accounts, are left to each council to devise in view of the widely differing circumstances and conditions which apply in different parts of the country. The primary records, statements and

accounts have to be supported by vouchers and be kept and examined by such officers as the council or the chief financial officer acting under the authority of the council, may direct.

(8) *Audit Regulations*, 1934.

These regulations amplify the provisions of the Local Government Act, 1933, and apply to the audit of accounts of local authorities which are subject to district audit in England and Wales. The matters dealt with by these regulations include the form of financial statement and certificate of the district auditor; notice of audit; certificate of compliance; production of accounts for audit; the preparation of an abstract of accounts; advertisements in local newspapers; the auditor's report and financial statement; and auditor's certificate.

(9) *Audit Stamp Duty (Local Authorities) Order*, 1938.

This order prescribes the scale of stamp duty payable by local authorities whose accounts are subject to audit by district auditors. The order does not apply to or affect the stamp duty chargeable on the Metropolitan Water Board, whose accounts are audited by district auditors by virtue of Section 19 of the Metropolis Water Act, 1902.

(10) *Financial Statement Orders*, 1938 *and* 1946.

These orders prescribe the form of financial statement to be used by local authorities in respect of such of their accounts as are audited by the district auditor.

(11) *Product of Rates and Precepts Rules*, 1948.

These orders prescribe the manner in which the product of a rate of 1d. in the £ is to be estimated and

calculated for the purpose of the Rating and Valuation Act, 1925, and the Local Government Act, 1948.

(12) *Education Accounts* (*Annual Statements*) *Regulations*, 1945.

These regulations apply to education accounts of county councils, county borough councils, joint boards, and the council of the Isles of Scilly. The annual statement must be prepared in duplicate in the prescribed form for the year to the 31st March, and show the income and expenditure in the exercise of any functions of the council acting as the local education authority. The form of the annual statutory education account prescribed is divided into 5 sections, *viz.*:

(i) Education Revenue Account.
(ii) Trust Funds.
(iii) Loan and Capital Accounts.
(iv) Sinking Fund Account.
(v) Apportionment of loan service charges and outstanding loan debt and sinking funds.

§ 6.—Internal Audit.

An internal audit may be looked upon as a recognised arrangement for securing a continuous and thorough check upon the financial transactions of a local authority. It should be regarded as supplementary to, and not in substitution for, an annual or independent audit. It may consist of a complete and comprehensive check embracing both the income and expenditure of the council, or only a check limited to the income of the council with the possible inclusion of control over the preparation of wages sheets, disbursement of wages, the supervision of stores and materials, and the organisation of a periodical stocktaking of consumable stores held in various depots.

Internal audit has been devised to enable the responsible financial officers to be assured that all details in connection with the accounts are correct. Where there is in operation a proper internal audit conducted by the staff, this relieves the auditor of the necessity of detailed checking up to a certain point. He should, however, exercise reasonable care by an examination of the scope of the internal audit, in order to see whether it properly covers the ground and is performed in an efficient manner. Internal audit has, in recent years, become recognised as an important integral part of the organisation for controlling the finances of a local authority. The advantages claimed for such an audit include—

(1) The presence of the internal auditor acts as a moral influence on the staff and promotes efficiency by compelling the members to keep the books of account entered up to date.

(2) Payments which involve cash disbursements such as wages and salaries may be checked before the actual payments are made.

(3) Important matters of principle which may arise may be dealt with expeditiously.

(4) Errors in account keeping which arise can be corrected whilst the points are fresh in the minds of the officers concerned.

(5) Constant examination of the books of account facilitates the improvement and modernisation of the system of accounting by revealing defects in the organisation.

(6) Frauds and peculations may be discovered in their early stages.

The internal audit system to be efficient and satisfactory, should be based on the following rules :—

(1) It should be complete in itself. There should be no scope for choice as to the amount of detailed checking which must be performed. Everything should be checked, otherwise the tendency would be to neglect the uninteresting and laborious portions, as for instance, the rate collection, which, as a matter of fact, is the most important. It should be complete in another aspect also ; the clerks engaged thereon should be entirely disconnected from any other work which is or could be subject to audit. Casual audit done by book-keepers or others in slack times gives the false impression of having an internal audit in operation which may, in fact, be misleading.

(2) It should be comprehensive in its range. No department, however self-contained it may consider itself to be, should be excluded. The internal audit should be wide enough to cover the checking of all classes of income from the primary entries up to the point where the cash is paid into the bank and the final records entered into the appropriate books.

(3) The internal audit staff should be wholly engaged on this work. They should be organised in such a way that their position as internal auditors should be recognised in all departments as part of the general organisation for exercising financial control.

Where such a system of internal audit is in operation, the professional auditor should thoroughly

overhaul it in order to satisfy himself that it can be reasonably accepted in such a way that he is not required to cover the same ground. It should be good enough to stand test of critical survey, and should relieve the professional auditor of a large volume of detailed work, and should give the assurance that details are not neglected. The scope and extent of internal audit organisation of the particular local authority has an important bearing upon the amount of audit fee which would be payable in the case of a professional audit.

§ 7.—Preparations for Audit.

The success or otherwise of an audit will be dependent upon the preparation of an audit programme, and a notebook summarising the sources of information to which the audit clerk must necessarily refer during the course of the audit. It will be obvious that there are no audit principles applying to the accounts of local authorities which differ from those which are involved in the examination of commercial accounts, and that the matters incidental to a commercial audit will similarly have to be recognised when a municipal audit is undertaken, *e.g.*, preparation of audit programmes and obtaining certificates of investments, stocks on hand, bank balances, etc.

There is no formal programme which is applicable to the audit of the accounts of all local authorities. The programme must be prepared after taking into consideration the scope of the internal audit, if any, and the books which are kept. The existence or otherwise of a system of internal check will modify the extent of the detailed work to be performed. An important source of information will be the minutes of

the committees and of the council of the local authority, and it must be remembered that any expenditure incurred by the local authority must be in accordance with law, and be authorised within the statutory powers of the council contained usually in standing orders. A useful record for the auditor for reference purposes would be a list of all financial provisions contained not only in general statutes but in the local Acts applicable to the particular local authority. There are many aspects of local authority activities which have their counterpart in commercial accounts, and have been referred to in other parts of this book, as, for example, house purchase on mortgage, etc.

§ 8.—Double Account System.

The statutory method of raising capital monies by a local authority, *viz.*, by loan, makes it necessary that these transactions are kept distinct from revenue transactions, and it is usual to find that the accounts are recorded on the double account system. There are definite statutory limitations imposed on local authorities to control borrowed money, and the following points should be observed when auditing the capital accounts :—

(1) All expenditure out of loan must be covered by a sanction from a government department. It is usual to open a separate account in the capital ledger for each service which has been specifically sanctioned by the appropriate government department. The auditor should examine the actual loan sanctions which have been received in order to verify the amount of the loan actually sanctioned, and the purpose for which such loan can be applied. It is

also necessary to observe that the Treasury consent has been received to the exercise of the loan sanction.

(2) Government sanctions usually contain a condition, that where the work is done by direct labour, no salaries or wages are to be charged in respect of permanent employees whose remuneration would ordinarily be borne by revenue account. The auditor should obtain from the departmental offices of the local authority certificates that the allocations of expenditure to loan accounts are properly chargeable thereto.

(3) Considerable sums are advanced to purchasers of houses under the Small Dwellings Acquisition Acts, and the repayments by the borrowers are generally calculated on an annuity basis. The rate of interest to be charged is fixed in accordance with the provisions of the Housing Act, 1936. The title and mortgage deeds should be examined, and the general audit followed on the lines suggested for Building Societies.

§ 9.—Loan Indebtedness.

Local authorities usually raise the money required for capital expenditure by mortgages secured on the general rate fund or by the issue of stock. There are generally two methods of raising money by mortgage; one is to borrow the exact amount of the loan sanction, the repayment coinciding with the terms stated in the sanction; the other is to borrow the sum repayable in full at a fixed date or after a certain notice. In the latter case, the amounts which are borrowed are

carried to a fund out of which are allocated the amounts required by the different sanctions. The following points should be observed in the audit of monies which are borrowed on mortgage :—

(1) Examine the minutes of the local authority which authorised the borrowing.

(2) Check the mortgage register which has to be kept by the clerk of the local authority with the register of documents sealed on behalf of the Council.

(3) Verify the amounts in respect of each mortgage with the entries in the bank pass book.

(4) Check the transfer of cash from the Mortgage Loans Fund to the respective cash accounts for each sanction.

(5) Check the final repayment which discharges a loan with the returned cancelled mortgage deed and see that a proper entry is recorded in the mortgage register.

(6) See that the proper contributions are made from the general rate fund or trading accounts in respect of the annual charge for interest and repayment of the loans.

§ 10.—Stock Issue.

Some local authorities are authorised to raise money by means of a stock issue, and in such cases the council may act through its own officials or by the agency of its bankers ; the audit will vary accordingly.

(a) Where the Bankers act as Agents.

In this case, it will be necessary to examine the Council minutes which will show details of the terms

of the stock issue, giving the name of the stock; the amount to be raised; the price of issue; the rate of interest; the date of repayment; the brokerage to be allowed; the banker's remuneration; and a reference to the Treasury consent to the issue.

The cash received should immediately be credited to the banking account of the local authority. The bankers will, when the issue is closed, furnish a statement showing particulars of the amount raised; the deductions for brokerage; remuneration and expenses of issue; and the dates on which the cash has been remitted. The bankers should, when the stock issue has been completed, send a list of the stock-holders and their holdings to the local authority.

(b) Where the Council issues the Stock.

In this case, the audit would be extended on the lines of an audit of a limited company's issue of stock, and would include the checking of the applications, allotments, amounts returned to applicants and stock-holders' personal accounts where it is inscribed, or the stock certificates where it is registered. The allocations to the respective sanctions should be checked with the resultant transfer of cash in the same way as mortgage loans, and any temporary investment of the proceeds of the stock issue and loans should be verified. The contribution from the general rate fund or trading accounts in respect of sinking funds, one of which must be opened for each sanction together with the annual charges for interest on stock which has been allocated, should also be checked. The amount of the sinking fund contribution is determined by the rate of accumulation generally on a 2½ per cent. basis, and the period of the sanction, the latter having nothing

whatever to do with the date when the stock itself must be redeemed.

§ 11.—Stock Regulations.

Redeemable stock may be issued by the councils of counties, boroughs (except metropolitan boroughs), and districts, in accordance with Section 204 of the Local Government Act, 1933. Some of the larger boroughs have powers to issue stock under the provisions of local Acts. A single code of regulations applying to the local authority empowered to issue stock has been issued by the Ministry of Health under the Act of 1933, and these regulations provide for :

(1) A Consent Order to be obtained from the Ministry of Health authorising the issue. This will specify the name of the issue, the rate of interest and the date of redemption together with the loan sanctions covered and the sinking fund contributions, and whether such fund is to be accumulating or non-accumulating.

(2) A Stock (Interest) Account to be kept for each class of stock to which the contributions for interest on stock appropriated to the various sanctions are to be carried and out of which the interest is to be paid.

(3) A Stock (Sinking Fund) Account to be established for each class of stock. To this account must be carried the annual contribution for the redemption of the sums appropriated to each sanction.

(4) The accumulations in the sinking fund may be either invested in statutory securities applied in redeeming the stock, or used for

any capital purposes. In the latter event, the money which is applied is treated not as an investment but as a transfer of the stock.

§ 12.—Capital Funds.

The monies which are raised by loan or stock under the various statutory provisions are, in effect, the capital of the local authority. Loans outstanding, plus the loans which have been redeemed, are the principal items which appear on the liabilities side of the balance sheet as *contras* to the capital assets. Where loan redemption is effected by means of sinking funds, the amount held in those funds will appear on the liabilities side of the capital portion of the Balance Sheet, and the sinking fund money in hand and invested will be shown on the assets side,

§ 13.—Consolidated Loans Fund.

Several local authorities have obtained powers under their local Acts which enable them to establish a Consolidated Loans Fund into which is paid all borrowed money (with certain exceptions), the proceeds of the sale of assets, and the amounts received from borrowing accounts on account of the repayment debt due from those accounts. The fund acts as an intermediary between the persons from whom money is borrowed and the several departments of the council which carry out capital works. The scheme for a Consolidated Loans Fund must receive the approval of the Minister of Health. The provisions made by the borrowing accounts for the repayment of debt are paid into the fund, and separate sinking fund accounts in respect of each loan sanction are eliminated. The revenue section of the fund comprises all amounts

received from borrowing accounts in respect of interest charges, financing and management expenses, together with details showing how those monies have been disbursed. In some cases, the local authority may transfer to the loans fund the uninvested balances or reserves, renewals, depreciations, insurance, superannuation and other special funds with the proviso that when such funds require monies for purposes for which they are established, the loans fund will repay to the lending fund the sums so required. All loans raised rank *pari passu* and the security for the loans is the whole of the rates revenue and other assets of the local authority. Available balances on the Consolidated Loans Fund may be utilised for new capital purposes if they are not immediately required for the redemption of debt.

The accounts must be prepared in prescribed form and be audited by district auditors or by the professional auditors of the local authority. The auditor's certificate must be entered on the Balance Sheet, the auditor being required to certify—

(1) that the Balance Sheet presents a true and complete statement of the loan debt of the council on the 31st March, and of the advances owing on that day to the Consolidated Loans Fund by the several borrowing accounts of the Council;

(2) that the said loan debt and advances are respectively within the statutory borrowing powers of the Council;

(3) that all conditions attaching to those borrowing powers in regard to repayment and provision for repayment have been duly observed by the Council;

(4) that during the year, all sums of money required by the..scheme to be paid into the Consolidated Loans Fund have been so paid, and have been duly allocated to capital or revenue in accordance with the provisions of that scheme.

§ 14.—The Audit of Revenue Income.

The income of a local authority is received from many sources and is collected in many departments, and the really effective check is by means of an internal audit. The professional auditor must, therefore, examine the position and assess how far his examination of the accounts of the local authority will relieve him of any liability on account of negligence. The fundamental principles which underlie the examination of income are—

(1) that all income has been credited to the proper account. The accounts of a local authority must provide reliable information which is required in connection with the yearly or half-yearly estimates of expenditure which are prepared as a basis upon which rates are fixed. They should provide adequate information for the purpose of reporting periodically on the progress of the collection of income under heads of service; also the information which is necessary to enable the compilation of returns required by government departments to be done efficiently. A distinction should be made between income and items of receipt which are, in effect, credits to expenditure. The returns which are required by the government departments will assist in this direction.

(2) that all income received is paid into the bank promptly. Any delay in paying money into the bank may be merely neglect on the part of the officers concerned or due to bad systems of accounting, but, nevertheless, it is frequently connected with minor embezzlements and frauds.

(3) that all income which is receivable is duly brought into account. This involves something more on the part of an auditor than a mere checking of entries from receipt books to journals or ledgers. In the accounts of some local authorities, it will be found that the income consists of cash receipts during the year to which are added outstanding debts, which are disclosed after the end of the financial year up to the time of the final closing of the books. In other cases, the debit in the debtors' ledger is made before and not after the cash has actually been received. If the scope of the audit is extended to ascertain whether income has been received which has not been brought into account, various problems arise which call for early solution. Where an internal audit system is in operation, it is not unreasonable to accept it as an adequate check up to the point of the money actually reaching the bank. Such an internal audit system should only be accepted after due examination to ascertain whether it is, in fact, effective.

The income of a local authority may be divided into the following main groups :—

(1) *Income from Rates.*

The Rating and Valuation Act, 1925, defines a rating authority as the council of every county borough, non-county borough, urban and rural district, and places upon the rating authority the duties of making, levying and collecting rates in their respective areas. Within the County of London, the metropolitan boroughs act as the rating authorities, and collect rates to cover their own requirements as well as the precepts which are received from the London County Council and the Metropolitan Police. A local rate is levied at an amount in the £ on the rateable value of each property shown in the valuation list, and only one rate is usually necessary for all purposes, and this is called the general rate. The rate collection accounts are subject to district audit. The rate book contains, in columnar form, particulars of each person assessed to the rate; the amount of the assessment; the calculation of the rate which is levied; the amounts actually collected, written off, or carried forward as arrears.

The special points to be observed in the audit of the rate collection accounts are—

(1) that all properties which are liable to be rated are actually included in the valuation list;

(2) that all legal deductions are in order, *e.g.*, that the provisions of the derating enactments are properly applied. In addition, certain allowances are made where the owners are rated direct; these are called "compounding allowances." In these cases, the owner's agreement and the lists of properties should be compared with the rate book.

(3) that all amounts written off as irrecoverable are duly authorised by a committee of the

local authority. Excusals on account of poverty will also require authorisation by the committee. Reductions on appeal to be verified with the list of proposals approved by the Assessment Committee. Amounts written off in cases of bankruptcy, empty properties, etc., should be certified by some person other than the collector who is responsible for the area.

(4) the collectors' payments into the bank should be checked. Almost in every instance where collectors have misappropriated rates, they have commenced by borrowing money from rate collections which is replaced by rates which are subsequently collected.

(2) *Government Grants.*

Government grants are paid under the provisions of the various statutes, and claims submitted to government departments are subject to check by the district auditor. The principal services for which government grants are paid are housing, education, and the exchequer equalisation grant under the provisions of the Local Government Act, 1948. In all cases where a grant is paid in respect of any service, the accounts of which come within the scope of the audit, the auditor should satisfy himself as to the accuracy of the basis and the calculation of the grant. It should be a requirement that a register of grants should be maintained by the chief financial officer of the local authority.

(3) *Rents.* (*Rents of Council property.*)

Local authorities are now becoming very large landlords, and it should be ascertained that all

properties which are or can be let are actually contained in the rental ledger. The items in the rental ledger can be verified by reference to the minutes of the local authority and the official terrier of council property. Amounts written off as irrecoverable should be authorised by the appropriate committee of the council.

(4) *Income from Trading Undertakings.*

Income in connection with any activities of the local authority such as the supply of water, the organisation of entertainments, swimming baths, etc., should be recorded in appropriate rentals or sundry debtors ledgers. Special attention should be given to the method of ascertaining the debit in each case.

(5) *Miscellaneous and Departmental Receipts.*

These will include interest on investments, licences, fees, search fees, recoverable private street works, sale of old stores, job works, and receipts from lodging houses, slaughter-houses, markets, conveniences, parks, etc. Most of these items consist of cash receipts and should primarily come within the scope of the internal audit. In this connection the preparation of statistics showing a comparison of the receipts for several accounting periods will be of considerable importance. The variations and fluctuations should be examined, and unless a satisfactory explanation is given, a detailed examination should be instituted. It is essential that the auditor should know the items of income which should be expected to be found in the various funds and undertakings of a local authority, as without this information items entirely omitted will escape detection.

A local authority publishes an annual abstract of accounts in detail, and this should be studied and compared with the abstract of accounts of a similar local authority. A list of the miscellaneous items of income compiled therefrom will materially assist in the audit. When preparing a programme of income audit, the methods adopted for the collection of the income should be studied. These include turnstiles, automatic locks, tickets, and official receipts, each with its own peculiar possibility for manipulation unless a strong control is kept thereon.

§ 15.—Audit of Expenditure.

The expenditure of a local authority is divided into expenditure out of loans and revenue expenditure, and a further sub-division is made when the expenditure is analysed to rate fund services or the accounts of a trading undertaking. The examination and correct allocation of expenditure is very important and is one to which the district auditor pays particular attention, with a view to ascertaining whether the local authority is keeping within its powers when incurring expenditure. The audit of expenditure will involve—

(1) the examination of vouchers in relation to the contractor's name, the date of the invoice, the nature of the payment, the certification by the officers responsible for ordering and receiving the goods, the account to which the the expenditure is allocated, and the inclusion of each item in an accounts schedule submitted to a committee of the local authority and duly signed by the chairman and two members of the committee when the accounts have been passed for payment.

(2) when examining the name of the tradesman or contractor, it should be remembered that members of the council are required to declare their interest in contracts and to abstain from taking part in the consideration of, or voting on, the proposed contract with the council.

(3) due regard should be given to the nature of the payment. This implies a general knowledge of the powers and duties of local authorities ; also knowledge of legal decisions affecting illegal expenditure.

(4) When checking the allocation of expenditure, it should be seen that each item is properly related to the account to which it is posted.

(5) a comparison should be made between the actual expenditure under each head of service, and the amounts included in the annual estimates, as it may be necessary to obtain a special resolution in certain cases to approve the excess expenditure.

(6) it is important and advisable that the system for the preparation and payment of wages should be inspected.

(7) particular attention should be paid to deductions from wages for national insurance and superannuation.

§ 16.—The Balance Sheet.

In a commercial audit there are certain definite points in connection with the examination of the Balance Sheet which are specifically considered. An examination of the form of a Balance Sheet prepared by a local authority will show that there are important

modifications owing to the fact that the local authority is not a business run for the purpose of making profits, nor is there any question of its possible insolvency. There are, in addition, statutory requirements for dividing the ordinary revenue expenditure from expenditure out of loans. The items which appear on the assets side of the Balance Sheet must be considered from the audit view as to whether they are statements of fact rather than valuations of property. The number of Balance Sheets to be verified will be dependant upon the separate funds which the council consider to be necessary or desirable in order to record their several transactions. The balances shown on the Balance Sheets should be checked back to the particular ledger account. Liabilities should be distinguished from fund surpluses, and asset balances from fund deficiencies or deferred charges.

The Balance Sheets are intended to present a complete statement of the financial position at the close of each year in respect of each fund, and of all matters then outstanding which will affect the accounts of the succeeding year.

In the publication of the statement of assets in the Balance Sheet practice varies, but usually one of the three following methods is adopted :—

(1) To give the cumulative total expenditure on capital account under the respective heads of service even though the assets covered have been reduced in value or are perhaps no longer in existence.

(2) The capital expenditure in respect of any item only stands as long as the loan out of which the expenditure was defrayed exists,

the capital expenditure being written down year by year by the amount of the provision for redemption of debt so that it is eliminated from the Balance Sheet when the loan is fully redeemed.

(3) The capital assets are divided for the purpose of treatment into assets of a realisable nature and assets of a non-realisable nature. The former are allowed to stand at cost, but the latter are reduced annually by the amount of the provision on loan redemption.

It cannot be claimed that any of the above methods is correct if the object is to show the assets on the Balance Sheet at their real value, because it is difficult to see the connection between a loan repayment and depreciation in value. Except in cases of trading undertakings, it is futile to attempt any valuation at all, and the argument is in favour of the first method, which can be claimed to be a statement of fact.

(a) **Depreciation.**

This item, which is common in commercial accounts, is seldom found in the accounts of local authorities. The method of financing capital expenditure by way of loan, and the repayment of those loans by provision made annually gives rise to a consideration which does not apply in commerce, *viz.*, a local authority is under no necessity to provide money for capital expenditure when it can be raised, as required, by loan, and that since the loan period which is sanctioned is linked to the probable effective life of the assets, the provision for loan redemption over the period of the loan sanction is sufficient provision for depreciation.

(b) Revenue Contributions to Capital Outlay.

Revenue contributions to capital outlay arise in two ways :—

(1) The charging of comparatively small items of expenditure made in excess of the loan sanction to a revenue account, and

(2) The defraying of capital expenditure out of revenue for items of a substantial nature under a policy adopted by the local authority in substitution for financing the expenditure out of loan.

(c) Verification of Assets and Liabilities.

The examination of detail and incorporation of balances on all open accounts in the Balance Sheet will have required the close attention of the auditor, but even after the Balance Sheet has been arithmetically agreed with the books of account, the essential duty of verifying the assets and liabilities must be performed. The book entries on an asset account or a liability account cannot be taken as definite proof that the assets actually exist or that the liability is definitely payable. The verification of assets will include the examination of all relevant documents in connection with freehold property, leasehold property, buildings in course of construction, plant and machinery, inventories, loans issued by the local authority on mortgage of freehold or leasehold property, investments, stocks of loose tools, transport assets, stocks and stores, revenue debtors, and cash at bank and in hand. The examination of liabilities will include a perusal of the register of mortgages, bonds, stock issues and other securities compared with loan sanctions and borrowing powers. The balances owing to sundry creditors may be vouched by reference to the creditors' statements and copy orders which have been uncleared.

(d) Aggregate Balance Sheet.

An Aggregate Balance Sheet which summarises the balances appearing in the separate Balance Sheets, must be entered in the ledger of the council, and here again it is preferable that loan and capital transactions be grouped separately from revenue transactions. Loans owing to superannuation, reserve and other special funds of the local authority should be shown separately from mortgages, stock, and other loans owing to outside lenders. An important provision in the accounts regulations is one which requires the chief financial officer, as soon as may be after the close of each year, to present to the local authority the final ledger accounts, duly balanced, in a bound book, and the accounts so presented shall be deemed to be the accounts of the council.

§ 17.—The Auditor's Report.

The Balance Sheet should be signed by the auditor, who should also give a general certificate for publication, in which a reference may be made to the auditor's report, if any. It is a matter of opinion as to whether the report should be published, but larger freedom is obtained for submitting matters of detail which may be criticised if it is understood that it is not intended for publication. It is perfectly clear, however, from Section 239 (3) (*d*) of the Local Government Act, 1933, that the observations of the auditor and his recommendations should be included in his certificate or be annexed thereto.

(a) General Certificate.

So far as the published accounts are concerned, it is suggested that a general certificate be given somewhat in the following form:—

"We have examined the books and accounts of the Corporation for the year ended 31st March, 19 , and the Aggregate Balance Sheet at that date.

"Incorporated in the Aggregate Balance Sheet are the subsidiary Balance Sheets of the Rating Fund and the Trading Undertakings and other sundry departments, and the Consolidated Loans Fund. We have not audited the Rating and Valuation Act, 1925, Accounts, or the accounts of the Education Committee, or the accounts of Public Assistance Committee, as these have been audited by the district auditor, but we have seen that the respective Balance Sheets have been properly incorporated in the Aggregate Balance Sheet.

"As regards the accounts audited by us, we have seen or verified the securities for the investments of the corporation held for the sinking funds or other purposes, also all documents of title in respect of properties acquired during the year, and loans on mortgage of small dwellings. We have also verified with the bankers the correctness of the bank balances as appearing in the books.

"All the information asked for by us has been furnished, and we hereby certify that in our opinion the Aggregate Balance Sheet and subsidiary accounts as signed by us are full and fair and correctly drawn up in accordance with the books so as to show the position of the corporation."

The certificate will of course be modified where necessary to meet the circumstances of each particular case.

(b) Report to the Finance Committee.

The report addressed to the Finance Committee should have regard to the following points.

(1) Any limits as to the scope of the audit. As a rule with local authorities, the auditors are appointed to audit the accounts. They should therefore call attention to the existence or otherwise of an internal audit system, and state how far that has modified their examination. The auditor should also name the accounts which are examined by the district auditor as being excluded from the scope of the audit.

(2) The system of accounts in operation. It is within the province of the auditor to express whether he is satisfied or not with the methods of accounting, and to make any suggestions for their improvement.

(3) The general financial position: This involves a summing up of the surpluses and deficiences on the various funds, and the general position with regard to reserve funds.

(4) The legality of expenditure: All expenditure of a local authority should be within its statutory powers, and the auditor should report upon all instances where the expenditure is in his opinion *ultra vires*.

(5) Apportionment of expenses: Certain central establishment expenses are usually apportioned as a charge on the trading undertakings. This apportionment may be quite inadequate, and a fair comparison is the amount allowed in arriving at the assessment for income tax purposes.

An auditor is sometimes asked to make a special report on circumstances relating to fraud and embezzlement. Such a report would be private and confidential and only a reference need be made to it in the general report. The special report requires careful drafting. It should definitely and concisely show how the fraud took place, the period which it covered, the reasons why it was possible, and suggestions for its prevention in the future.

CHAPTER XIV

INVESTIGATIONS

§ 1.—The Nature of Investigations.

The term "Investigation" implies an examination of the accounts of a business for some *special* purpose. It differs from an audit inasmuch as it is not primarily carried out for the purpose of ascertaining whether the Balance Sheet of the business is properly drawn up or not, but rather for the purpose of obtaining information of a particular nature required by the client or, in the case of an investigation of fraud, for the purpose of ascertaining its extent.

The various classes of investigation in practice are too numerous to be dealt with, but the following may be indicated :—

1. On behalf of an individual or a firm proposing to buy a business.
2. On behalf of the promoters of a proposed company with a view to the preparation of a report on profits for insertion in a prospectus.
3. On behalf of an incoming partner.
4. On behalf of a bank for purposes of credit.
5. On behalf of a person intending to invest in a private business, a firm, or a company.
6. With a view to arriving at a valuation of the shares of a company.
7. On behalf of the proprietors of a business where fraud is suspected or known to have taken place.
8. Investigations under Sections 164 and 165 of the Companies Act, 1948.

9. In connection with taxation liabilities (" Back Duty " investigations).

The accountant, when asked to investigate, should obtain written instructions from his clients as to the period to be covered by the investigation, and the exact purpose for which it is required. The amount of detail work performed is not usually so great as in the case of an audit, but this must be determined according to the circumstances of each particular case. The *purpose* of the investigation must be borne in mind throughout, as this will indicate to the accountant the particular matters to which he must give special attention. Where the accounts have been audited in the past, and proper Balance Sheets are available, the matter is considerably simplified. As the accountant is consulted as an expert, he must himself decide the extent to which the investigation should be carried, having regard to the information which he may consider will be of importance to his client, and to the manner in which his certificate or report will be utilised. The greatest care should always be taken in investigations to preserve all working papers. These should link up the figurès shown by the books of the undertaking with the final figures produced by the accountant. In investigations of fraud it is conceivable that the accountant may be called upon to give evidence, and he will then find that full working papers are essential.

§ 2.—Investigation on behalf of an Individual or a Firm proposing to buy a Business.

(a) The Extent of the Investigation.

The accountant undertaking such an investigation must bear in mind that a person proposing to purchase

a business wishes to obtain as much information about that business as possible, in order that he may form an opinion as to whether or not it is worth buying and, if he decides to buy it, how much he should pay for it.

Where the books have been properly kept, and the accounts regularly audited, the accountant is entitled to assume that the books are arithmetically correct. Where, however, the accounts have not been audited, it may be necessary for records to be examined much more fully. The client will, undoubtedly, require information not only as to the assets and liabilities at the date of the purchase, but also as to the trend of sales, and the gross and net profits over a number of years, and it will, therefore, be necessary to examine the Profit and Loss Accounts as well as the Balance Sheets, and to analyse the accounts for the purpose of comparision.

The Trading and Profit and Loss Accounts for each year should be redrafted on a uniform basis, so that a true comparison may be made between one year and another. When this has been done, the accounts should be set out in columnar form with the addition of a percentage column for each year in which should be entered the percentage to turnover of each item of expenditure. Any material variations in these percentages from year to year will indicate items to which particular attention must be paid, and will also reveal any special expenditure incurred in any year in excess of the normal—as, for instance, in the case of advertising. The Balance Sheets should also be set out in columnar form, and from a comparison of the figures much valuable information may be gleaned which will be of material assistance in the

course of the investigation. Having obtained all the information available in this manner, the accountant will be able to decide on the extent of his examination.

In many investigations, where the purchaser is familiar with the type of undertaking and the locality, he is mainly concerned with obtaining reliable information in regard to turnover, since from experience he will know the cost of production and the selling and administrative expenses which are normally incurred. The accountant should prepare a statement of sales, so that a comparison between years and months may be effected. The cause of abnormal fluctuations in turnover should be enquired into. In arriving at the figure of sales, returns should be deducted as well as trade discount and all allowances, in order to disclose the *effective* net sales. Where the purchaser has no experience of the type of business which he proposes to acquire or is unfamiliar with conditions in the particular locality, he will require, in addition to details of sales, information covering the whole of the Trading Account and Profit and Loss Account.

In examining the Trading Accounts it should be seen whether the percentages of the various items of expenditure to turnover are constant, or whether they are subject to variation. In this connection, care must be taken, when redrafting the Trading Accounts, to set out the items in such a way that the actual cost of each element of expenditure is revealed, and the percentage thereof to turnover calculated. For example, in the case of stores and stocks the closing stock should be deducted from the sum of the opening stock and purchases, thus showing clearly the cost of the stores *actually consumed* or of the *goods actually sold.* It will readily be understood that the

percentage of such cost to turnover may remain constant, whilst the percentages of opening and closing stocks and purchases, individually vary. The causes of variations revealed by such percentages *must* be ascertained. They may be due to a rise or fall in the cost of materials, manufacturing expenses, sale prices, rates of wages, or to variations in the types of product sold, etc., but the possibility that they are due to errors or inflations in the value of the stocks, fictitious sales or other fraudulent manipulation of the accounts, must not be overlooked. The stocks at the end of each period should be compared and tested with the stock records, and the accountant should ascertain that the basis of valuation of stock has been uniform throughout. If there is a considerable increase in the value of the stock held, without a corresponding increase in trade or rise in the prices of raw materials, this may be due to inflation of values, which may be expected to cause a variation in the percentage of the cost of goods sold.

The Trading Accounts for the last two financial years, and the records for the period from the date of the last Balance Sheet to the date of the investigation must be examined in greater detail, particularly where the gross profit has increased as compared with former years, as it is possible that, with a view to the sale of the business, manipulations may have been carried out with the object of inflating the profits of these years. This would have the result of disclosing a more prosperous position than was actually the case and, since the price payable for goodwill is usually calculated on the basis of profits or turnover, it would also have the effect of increasing the purchase consideration. The most usual methods of inflating sales are—

1. The inclusion of goods on sale or return, or on consignment as completed sales.
2. Ante-dating invoices relating to the period subsequent to that covered by the accounts.
3. The inclusion of fictitious invoices for credit sales or the increase of cash sales by payments to the business by the proprietor.

Inflation of gross profit may also be effected by increasing the value of closing stock, or by omitting purchases, wages, or other manufacturing expenses.

It will be necessary, therefore, for the accountant to test the sales with the physical stock records, the Order Book, the Goods Outwards Book, or such other records as may be available. Where no physical stock records are kept, or where those in use are inadequate, the accountant must scrutinise the sales with great care, and should note whether they have fallen since the date of the last Balance Sheet, or the date to which the investigation is being taken. The period following the period under investigation should also be scanned closely for rebates, allowances, returns, etc., which are applicable to the period under investigation, as if fictitious sales have been included in the last year, entries of this character will be necessary to eliminate the fictitious debts created.

In order to ascertain whether purchases have been omitted, the Goods Inwards Book should be tested with the Bought Journal, and such creditors' statements as are available tested exhaustively with the creditors' ledger. Workers' time cards, job cards, national insurance cards, etc., must be tested with the wages book in order to ascertain that all wages have been included in the accounts, and the reasons

for any marked decrease in expenditure must be enquired into.

In making an analysis of the sales the accountant should extract all unusual profits resulting, for example, from exceptional contracts, or where it has been found more profitable to re-sell raw material than to use it for the manufacture of goods. If it is considered that such items should be included, it is submitted that the profit thereon should be shown in the Profit and Loss Account, and not in the Trading Account, in order that the rate of gross profit on normal trading operations is not obscured.

In a similar manner it will be necessary to make an analysis of the Profit and Loss Account items. The accountant should investigate any items that show undue variation. The last year and the period following it should be examined in greater detail in order to see that there has been no manipulation to increase the net profit. Vouchers should be seen for all payments made after the close of the period under investigation, to ensure that all outstanding accounts have been provided for during that period. Manipulations may be effected by the omission of outstanding liabilities, by insufficient provision for bad debts or depreciation, by starving the business of necessary expenditure on repairs and renewals, etc., or by paying business liabilities out of private funds. The basis upon which bad debts have been provided for should be ascertained, and the debtors' balances at the close of the period checked in detail with a view to ascertaining that sufficient provision has been made.

The opening Balance Sheet should be checked. The Impersonal Ledger should be examined, and the

postings thereto of all the totals from the subsidiary books should be checked and the cash postings tested. The postings of the nominal account balances should be checked at the end of each year to the Profit and Loss Accounts. As regards vouching, it is not usually considered necessary to vouch the payments, even where no audit has been previously performed. The object of the investigation is to ascertain the profits, and to verify the existence and value of assets, and the accountant is not concerned with the manner in which payments have been made, or whether they can be satisfactorily vouched. It is, however, important that all capital expenditure should be vouched, in order to ascertain that no revenue expenditure has been capitalised and profits thus inflated. The asset accounts should be checked in detail, care being taken to see that all items are properly chargeable to capital, and are not items of expenditure in the form of repairs and renewals, which should have been charged to revenue.

The closing Balance Sheet for the period should be checked in detail. If there has been an independent valuation of the assets, the correct figures should be incorporated, otherwise it should be seen that adequate depreciation has been written off. Any assets which are no longer effective or in general use should be shown separately, and it is often advantageous to show the assets in the Statement of Assets and Liabilities in the same groups and order as those in which the income derived therefrom is shown in the Profit and Loss Statement. Expenditure on advertising which has been carried forward as advertising goodwill should receive careful consideration, and it is suggested that in the majority of cases it should be written off.

The value of the goodwill of the business, unless it has already been agreed, may have to be ascertained. Goodwill is an asset which it is difficult to value accurately, and it is impossible to be dogmatic as to the basis upon which the valuation should be computed; even among accountants there is no settled opinion. There are, however, in most trades recognised methods of valuing goodwill. In many cases it is customary to take the average past profits for a definite number of years and multiply such average by an agreed number and to regard the result as the value of goodwill. This is expressed as "so many years purchase on an average of so many years." This method is not scientific and will result in a value being placed upon goodwill which may be entirely erroneous when considered in the light of the ratio of the profits earned to the total capital employed in the business.

Another method of arriving at the value of goodwill is to base it upon *super-profits.* These are defined by Mr. P. D. Leake as "the amount by which revenue, increase in value, or other advantage received exceeds any or all economic expenditure." Economic expenditure is in turn defined as including "any or all current expenses, expired capital outlay on wasting assets (depreciation) other than goodwill, personal remuneration sufficient to secure continued successful management (which may possibly need ability of a high order) and a rate of interest on capital invested which will attract and retain any necessary capital having regard to the degree of risk incidental to the character of the undertaking." The value of goodwill is arrived at by taking the present value of an agreed number of annuities equal to the super-profits. The rate of interest employed in finding the present value

of the annuities is the same as that used in arriving at the super-profits. This method suffers from the disadvantages—that the rate of interest has to be estimated and the number of annuities agreed.

A third method does away with the difficulty of agreeing on a number of years purchase. Under this method the whole question is regarded from the point of view of the value of the business as an investment. The rate of interest which may fairly be expected from the employment of capital in the business is fixed by reference mainly to the rate which experience shows can be obtained in businesses of a like nature, due regard being had to the risks to be incurred by the capital, and the value of the assets ascertained on the normal basis as a going concern. Taking the profits which it is considered will be maintained and the rate of interest expected, the maximum amount that the purchaser will pay for the business, lock, stock and barrel, is arrived at. The difference between this sum and the net *tangible* assets is the price paid for goodwill.

The connection between the rate of interest, the value of the assets and the risk lies in the fact that where the value of the tangible assets is large and they are of a realisable nature, they form some security for the capital employed. Where a business has tangible assets of small value, the maintainable profits probably result from goodwill which is not inherent in the assets, and the risk is consequently greater.

Illustration.

The maintainable profits of a business are £10,000. The purchaser considers that the value of management

is £2,000. The net tangible assets are valued at £95,000. Goodwill is arrived at as follows:—

Maintainable profit	£10,000
Less : Management remuneration ..	2,000
Return on Capital	£8,000

If the purchaser considers that a fair rate of interest would be 8%, the value of goodwill would be—

Capital required to produce £8,000 per annum at 8%	£100,000
Less : Tangible assets..	95,000
Value of Goodwill	£5,000

This method is strictly one of valuing, not so much the goodwill as the *business* as a profit earning concern. It will be realised that without the goodwill the value of the fixed assets, shorn of their earning power, would be vastly inferior to the value of the same assets when considered in conjunction with the goodwill. In fact, the goodwill cannot fairly be valued apart from the fixed assets, nor the fixed assets apart from the goodwill. Together they constitute the source of the capacity to earn profits from which their value to the business as a going concern is derived. Strictly, therefore, the fixed assets and the goodwill should be considered as one asset for the purpose of valuation, but where a value is placed upon the fixed assets, the difference between the total value of the business as a profit earning investment and the value attributed to the tangible assets may be regarded as the value of the goodwill.

(b) The usual Adjustments necessary.

Assuming the accountant has investigated the accounts as far as he considers necessary and is of opinion that they are correct, there will remain a considerable number of adjustments to be made before the profits upon which the report to the purchaser must be based can be arrived at. The object of the report is to afford the purchaser information as to the achievements of the business in the past, from which he may form an opinion as to its probable earning capacity in the future. For this reason, although the report should deal with past facts, it is necessary to adjust the past profits of the business to conform to the conditions that will obtain after the purchase; *i.e.*, to show what the net profits would have been, *based on the same turnover*, had the conditions of management, finance, etc., been the same in past years as those which will prevail after the purchase.

It will usually be found necessary to add back the following items to profits:—

1. Interest on partners' capital and current accounts, and also partners' salaries, unless these represent a fair remuneration for management.
2. Interest on loans and overdrafts (if any), except where any of the loans will be taken over by the purchaser. Otherwise, it is to be assumed that the purchaser will provide sufficient working capital, in which case such charges will not be incurred.
3. Rent—if the purchaser is purchasing the trade premises hitherto rented by the vendor.

4. Discount on purchases—in-so-far as the business, from lack of working capital, has not been able to take advantage of all discounts.
5. Exceptional losses such as those arising by reason of insufficient insurance, although in such cases the full insurance premium should be charged; defalcations and costs and damages incurred by actions-at-law and other losses not arising in the ordinary course of business.
6. Capital losses such as loss on sale of fixed assets or investments.
7. Any additions or improvements of a capital nature that have been charged to Profit and Loss Account.
8. Any excessive provisions for bad debts or other contingencies.
9. Excessive provision for depreciation.

The following items should be deducted from the profits :—

1. Income from assets not being taken over by the purchaser.
2. Rent, if no charge has been made for this in the Profit and Loss Accounts, and the purchaser is not acquiring the trade premises.
3. Exceptional profits, such as compensation for compulsory removal of premises, speculation profits, etc.
4. Capital profits, such as profits on investments or on the sale of fixed assets.
5. Adequate depreciation, where this has not been provided for.

6. A reasonable sum for management remuneration, if none has been charged in the accounts.

The question of depreciation is a most difficult matter to deal with. It is preferable for the profits to be stated, after providing an adequate amount for depreciation, if this can be arranged. As the values upon which the purchaser will in future base the provision for depreciation will in most cases be different from those adopted by the vendor in the past, it is clear that unless the rates of depreciation are based upon the sale values, the inclusion of charges for depreciation that may have been sufficient in the past will be misleading. In other cases, difficulty may be experienced in arriving at a proper rate of depreciation having regard to the nature of the assets. Where accurate provision cannot be made, the usual charges for depreciation should be added to the profits, and the report should state clearly that no provision for depreciation has been made.

(c) The Report.

The report should be worded in a clear and unambiguous manner, and must state the precise period covered by the investigation. It should contain all information which may be of assistance to the purchaser, and the accountant should not confine himself only to figures. He should, however, be very careful to avoid any statement which might lead his client to regard his remarks as predictions or estimates for the future. Where the adjustments made are merely of an ordinary nature, it is sometimes thought sufficient to say that all adjustments necessary in the opinion of the accountant have been made, but all adjustments involving special items of importance should be referred to specifically. The

report should set out the information which the client requires in sufficient detail to enable him to comprehend the exact position of the undertaking. In order to do this a number of matters which will affect the future will have to be dealt with. For example, where, owing to insufficiency of working capital the business was not able to avail itself of all cash discounts, this should be pointed out, and the effect upon the past profits should be shown. The approximate number of times per annum the capital is turned over should be calculated, as this will vitally affect the amount of working capital required. The business may be fortunate in the possession of an efficient manager, and his willingness to continue in that capacity is an item of information which is of value to an intending purchaser. Where the manager is not continuing in the business, the accountant should make adequate provision for management salaries, but he should state clearly in his report the amount which he has provided therefor. All open contracts which will affect the future of the business, such as agreements to sell goods at a future date at an agreed price, should be set out in full, and it should be indicated whether it would be possible to rescind them if desired. Any necessary provisions in respect of these items should be made. The manner in which taxation has been dealt with in arriving at the maintainable profits should be clearly set out in the report.

Reference should also be made to the tenure on which the business premises are held. If the premises are held on a lease, of which only a short term remains unexpired, the question as to whether any difficulty

will be experienced in obtaining a renewal of the lease at a reasonable rent may have a vital bearing upon the desirability or otherwise of acquiring the business.

§ 3.—Investigation on behalf of the promoters of a proposed Company.

Under the Companies Act, 1948, any prospectus issued by or on behalf of a company or by or on behalf of any person who is, or has been, engaged or interested in the formation of a company, must set out the reports specified in Part II of the Fourth Schedule of that Act. (*See* Chapter VII, § 3.)

An accountant making an investigation of the accounts of a business proposed to be acquired by a company should remember that he is not only responsible to his clients for the work he performs, but also that he bears no small responsibility towards the public, since, on the faith of his report as an expert the public will be asked to subscribe for shares in the company. It is, therefore, important that the accountant should ascertain as far as he can the *bonâ fides* of all parties interested in the matter, since in the event of the new company proving unsuccessful and legal proceedings being taken he is likely to find himself involved. As has already been pointed out, it is essential that he should retain a complete record of all material information, and of the manner in which he has arrived at the figures he ultimately reports upon, so that he may be in a position to substantiate his report if called upon to do so.

The Companies Act, 1948, requires the prospectus to disclose the profits or losses of five years, but it is very common for the accountant to be asked by the

promoters to investigate and report upon the profits of a larger number of years. A minimum period of ten years (or from the date of incorporation if the company has not been in existence for ten years) is required by the council of the London Stock Exchange to be shown as a condition of granting a quotation. The object of the investigation is to arrive at the normal trading profits during the period, and the accountant should confine himself to ascertainable facts, and not indulge in calculations or problematical estimates of future operations.

The routine to be followed and the points to be borne in mind have already been set out at length in the preceding section, but an investigation with a view to giving a report as to profits for publication in a prospectus is of narrower scope than an investigation on behalf of an intending purchaser. Only those matters directly affecting the figures of normal trading profits for the periods should be examined and reported upon.

When, in the course of his investigation, the accountant ascertains that the company has entered into *exceptional* forward commitments which may affect adversely the position of future profits, he should refer thereto in his report (*Rex* v. *Bishirgian and Others*, 1936, Acct. 28th March, 1936, p. 494 *et seq.*), although it would appear that there is no necessity to refer to *normal* commitments of this nature. In the course of his judgment the Lord Chief Justice said: "the future commitments of a normal business are one thing; the future commitments of a colossal gamble are different, not merely in degree, but in kind........the financing, as it is called, is different; the risks are different, and to advertise a business

as an ordinary business seeking development, when money is really being asked for to feed and supply an ambitious gamble is simply deceit." This case did not concern the auditors of the company, who were shown to have no knowledge of the excessive commitments, but it is clear therefrom that when a prospectus is issued by a company in such circumstances, the non-disclosure of abnormal future commitments may render the document "a cheat from beginning to end." An auditor who gave a report on profits for inclusion in such a prospectus, *knowing of the non-disclosure*, might find himself involved with the directors in a criminal charge.

The wording of the report should be clear, and the precise periods covered by the investigation should be set out. The profits for *each year* must be set out separately; a statement of average profits will not satisfy the provisions of the Act, although such a statement may be given by way of additional information. If the accountant has considered it necessary to make adjustments in arriving at the figures of profits or losses or assets and liabilities referred to in his report, this fact must be mentioned therein. If any of such adjustments involve special items of importance or magnitude it is considered that specific reference to the nature and amount of such items should be made.

§ 4.—Investigation on behalf of an incoming Partner.

In addition to the examination which it is necessary to make on behalf of an intending purchaser, the accountant should include in his report to a prospective incoming partner all information which comes to his

knowledge that may be of importance to his client in arriving at a decision as to whether he should continue the negotiations. The accountant should obtain a draft copy of the proposed partnership agreement, so that he may be in a position to advise his client as to whether or not the terms thereof appear to be reasonable. Special attention should be paid to the values at which the various assets are to be brought into the new partnership's books, as if they are over-valued the capitals of the continuing partners will be inflated, and the incoming partner might be prejudiced in the event of a dissolution. If the proposed partnership is to take over the debtors and liabilities of the old partnership, special care must be taken to see that adequate provision has been made in respect of bad debts, or that if bad debts are incurred, the continuing partners will be responsible for them personally. Attention should be paid to the treatment of goodwill, and the amount which the incoming partner is required to pay for his share of this asset.

The accountant should ascertain as far as possible the reason why the firm wishes to admit a new partner, as this may be due to financial weakness. Should the accountant receive any indication that any of the continuing partners are involved personally in financial difficulties he should report this fact to his client.

§ 5.—Investigation on behalf of a Bank for purposes of Credit.

It is usual for banks, when a loan has been asked for, to demand a copy of the customer's latest Balance Sheet, in order to ascertain what assets are available to

afford security for the loan and the general financial condition of the business.

Where, however, a business wishes to be allowed to overdraw at certain periods, or to a certain extent, or wishes the bank to accept bills on its behalf, the bank requires more detailed information, and an accountant is often called in to carry out an investigation for this purpose. Bankers are interested to know the reason for the required overdrafts or loans, as they are careful to see that in such cases the money is usefully employed. Further, they wish to know to what extent the loan is liquid.

The accountant should prepare a statement of assets and liabilities, giving in particular the following information :—

1. *Sundry Debtors and Bills Receivable.*

Amount due from trade debtors within the period of credit.

Amount due from trade debtors beyond the period of credit.

Amount due from partners, directors, officers and employees.

Amount due from branches or subsidiaries.

Amount due on bills, divided into short bills and others.

Amount of reserve to cover discount and bad and doubtful debts.

Nature and amount of any debts or bills pledged or assigned.

2. *Stock.*

Finished stock, stating method of pricing.

Work-in-progress, stating method of pricing.

Raw materials, etc., stating method of pricing.

Amount of stock included above held under trust receipts.

Stock held on consignment, and whether it has been included above.

Amount of stock pledged as collateral for loans or advances.

3. *Real Property, Plant, Buildings, Fixtures and Fittings.*

A full description should be given of each item, and the method of valuation clearly shown. Particulars should be given of the method of writing off depreciation, and any recent valuations by an expert valuer should be set out. Full particulars and the amount of all charges on the property, etc., should be detailed.

4. *Investments.*

A list should be given of the investments showing the nominal and market values. Where any of these have been lodged as security for loans or advances, full details should be given.

5. *Secured Liabilities.*

Details should be given of all debentures and other secured liabilities, showing the amount outstanding, the date repayable, and whether, in the case of debentures, they have been issued as collateral security for an overdraft. Details should be given of the assets charged, and particulars of the provision made for meeting them at maturity must be given.

6. *Insurance.*

A list should be given of all insurance policies, stating the nature of the policy, the assets covered, and the amount. It should be borne in mind that where the business is entirely dependent for its existence on assets such as a factory, advances may more easily be secured if a Loss of Profits Policy exists.

The accountant should also examine the Profit and Loss Account for the last period and, if required, for earlier years in order to ascertain the maintainable profits. The method of doing this has already been dealt with earlier in this Chapter.

The report should state the method of collecting debts, and the period of credit and the terms upon which sales are made. Particulars should be given of all contingent liabilities and especially in respect of the following :—

1. Bills discounted.
2. Accommodation bills.
3. Guarantees.
4. Contracts or agreements.
5. Pending law suits and arbitrations.
6. Shares and debentures of subsidiaries where the dividends or interest have been guaranteed.

The accountant should state whether in his opinion the proposed loan or advance or overdraft will be usefully employed, and he should give the reason for requiring it.

§ 6.—Investigation on behalf of a Person intending to Invest in a Private Business, a Firm, or a Company.

An investigation for this purpose should cover the same ground as an examination on behalf of a

bank for credit purposes; but as an investor does not require his investment to be as liquid as does a banker, greater attention must be given to the maintainable profits and the trend of business.

In the case of a private business or a firm, the accountant should scrutinise carefully the agreement between the investor and the business or firm, and see that its terms are advantageous to his client and that reasonable security is afforded. In most cases of this nature the lender is well acquainted with the character of the proprietors of the business or the members of the firm, but where he is not familiar with them, the accountant should, if he thinks it desirable, inform his client of any facts which render it undesirable for the investment to be made. For example, if there is dissension among the partners of a business, it is possible that the firm may be dissolved in the near future.

In the case of a loan to a company, the Memorandum and Articles should be scrutinised to see that the loan is within the borrowing powers of the company and of the directors. If it is *ultra vires* the directors a resolution should be passed by the company in general meeting authorising them to borrow the money. It may also be the case that the money will be invested permanently in the business in the form of shares or debentures. The terms of the issue should be scrutinised carefully, and it should be seen in the case of debentures that adequate provision is being made for repayment at maturity. In addition to verifying the existence of the property charged, the company's file at Bush House should be examined, in order to see that there are no charges entered in the register of charges which are not entered in the

company's register of charges. The accountant should satisfy himself that the money can be usefully employed, and, where the additional funds are required for a specific purpose, that the sum asked for will be sufficient to accomplish that purpose.

§ 7.—Investigation with a view to arriving at the Valuation of the Shares of a Company.

It is common in private companies for the Articles to provide that shares may only be transferred to persons approved by the directors, and that the shares are to be transferred at a value fixed by the directors or, in the case of the transferor disagreeing, by the auditors of the company acting in their capacity as expert accountants.

When making an examination for this purpose, it is usual for the accountant to prepare a detailed statement of the assets and liabilities of the company including therein the assets on the usual bases; that is to say, the fixed assets will be valued at cost price less adequate depreciation, and the current assets at cost or market price, whichever may be the lower. Where the assets have been valued by an outside valuer, the figures so obtained should be employed, subject to any necessary adjustments to bring them up to date. Any secret assets should be brought into account, and the accountant must see that adequate provisions have been made for depreciation, discounts, bad and doubtful debts and for any contingent liabilities.

The goodwill should be valued by one of the methods set out in § 2. From the total value of the assets thus ascertained must be deducted the amounts due to debenture holders and the total of other

liabilities, in order to arrive at the figure of net assets available to the shareholders.

The accountant must then examine the Memorandum and Articles of the company, in order to ascertain the exact rights attaching to the various classes of shares in the event of liquidation, and the extent to which each class is entitled to participate in profits.

The valuation of the shares, however, will not necessarily bear any direct relation to the value of the assets, except to the extent that it may afford some indication of the degree of security attaching to the capital; since obviously where the capital is fully represented by assets of a tangible nature with perhaps a comfortable margin over, shareholders will experience a greater feeling of security than if such were not the case. But, as already explained in this chapter, the value of the tangible assets is itself dependent, to a large extent, upon the capacity of the business to earn profits, and, if an attempt were made to realise the fixed assets separately from the business a considerable loss would almost certainly be sustained.

Even the question of the security of the capital, therefore, would not be dependent wholly, or even primarily, upon the value of the assets, but would depend to a great extent upon the steadiness of the earnings and the regularity with which dividends are paid.

For the purpose of arriving at a fair valuation of shares, it would first be necessary to estimate the profits which the business is capable of earning in the future. As a general rule, the only guide to future earnings is the profits earned in the past.

The average profits of a cycle of years should therefore be taken, and such adjustments made thereto as may be considered necessary to give effect to any known facts or contingencies which may cause the future earnings to diverge from the past average. Thus, where it appears that there has been a progressive increase or decrease in sales, this should be allowed for, or where insufficient depreciation has been charged or profits have been inflated in the past by the omission to make other necessary provisions, some deduction therefor should be made. The possible effect upon future earnings of new competition, the loss of a monopoly, the introduction of substitutes for the company's products, tariffs, quotas and other political intervention, and other contingencies appropriate to the particular case, should be considered.

When, however, a figure has been arrived at which may be deemed to represent the average profits which the business is capable of earning, this amount, after deducting the sum necessary to pay the dividend on any preference share capital of the company, and also any sum which it may be considered desirable to withhold from distribution in order to create necessary reserves, may be regarded as the income arising on the ordinary share capital, the value of which may then be found by capitalising the profits available for the ordinary shares at the rate of interest to be expected as shown by the yield obtained on investments in similar companies.

Thus, assuming the issued capital of a company to consist of 100,000 £1 ordinary shares and 100,000 £1 8% preference shares, and the average profits of the company to be £20,100 per annum, the value of the ordinary shares may be calculated as follows :—

Average Profits		£20,100
Deduct Amount required to pay Preference Share Dividend	£8,000	
Annual transfer from profit to maintain necessary reserves, say	3,000	
		11,000
Profit available for Ordinary Shareholders		£9,100

Assuming it is found by examining Stock Exchange quotations that the average yield to be obtained upon ordinary shares in similar companies is, say, 7%, the value of the ordinary share capital would be $£\frac{9,100 \times 100}{7} = £130,000$.

The value of each ordinary share would therefore be $£\frac{130,000}{100,000} = £1$ 6s. 0d. per share.

Similarly, if the yield to be obtained on preference shares in similar companies is say, 6%, the value of the 8% preference shares in the above company would be $\frac{8}{6}$ of £1=£1 6s. 8d. each.

The price which a person would be prepared to pay for shares may further be affected by the supply of and demand for shares in the particular company, by the accumulated reserves of the company and the possibility of bonus distributions; by a projected change in the management, and by numerous other factors the effect of which it is impossible to estimate, and which may be ignored in arriving at the true *investment* value of the shares, since they introduce features of a speculative character.

Each class of share should be valued on a similar basis, but it must be remembered that the yield to

be expected will increase with the risk involved and the stage at which each class will rank for dividend. A greater yield is thus expected from ordinary shares than from preference shares. Deferred shares, which rank for dividend after the ordinary shares, would be expected to produce a still greater return owing to the increasing risk of profits being insufficient to furnish a dividend for prior classes.

§ 8.—Investigation for Fraud.

It has been pointed out in Chapter I, § 3, that fraud may be divided into two classes, *viz*, defalcations involving misappropriations either of money or goods, or the manipulation of accounts, not involving defalcations. The conduct of investigations where fraud is suspected or known to have taken place varies very much according to the circumstances of each case, and it is not possible to consider the matter here except in the most general manner.

The fraudulent manipulation of accounts without corresponding defalcations has already been considered from time to time in the course of this work, and usually takes the form of the inflation of assets, or the omission of liabilities, for the purpose of making the position of a business appear to be better than it really is, or enabling profits to be distributed that have not been earned.

Defalcations involving misappropriations of stock vary so much according to the nature of the goods and the trade carried on that it is not practicable to discuss the subject here; but defalcations involving misappropriations of cash present many features in common, and it may be convenient to indicate the general course of procedure where an investigation of

this nature is made, taking as an instance the case of a trading business where fraud has been carried out by some individual in charge of the books and cash, who has absconded.

Full enquiries should be made as to the authority exercised by the defaulting clerk and the nature of his duties, as this will give some indication of the opportunities of which he may have taken advantage. Assuming that the clerk has been in general control of the books and has been subject to little or no supervision, the accountant would be compelled to make a complete investigation from a date arranged with the proprietors of the business, paying particular attention, *inter alia,* to the following points :—

The cash book should be cast and vouched in detail, and certificates of the opening and closing bank balances obtained from the bank. The pass-book should be checked completely with the cash book, particular attention being paid to the dates when the receipts are paid in, and to ascertaining that each day's receipts have been banked intact.

Where moneys received from debtors have been misappropriated, it is common to find that, in order to prevent the debtor's account in the Sales Ledger appearing overdue, moneys received from subsequent debtors are placed to the credit of the debtor whose remittance was originally misappropriated, this process being continued indefinitely. In such cases it may become necessary for the cashier to divide certain remittances, in order to obtain the exact amounts necessary for his purpose, and one method of discovering whether this has been done is to examine the original paying-in slips *at the bank,* and compare them with the counterfoils of the paying-in book.

The slip presented to the bank will contain the correct record of the amount of each cheque, whereas the counterfoil will show any division that may have taken place. This also serves as check upon the improper manipulation of discounts. All discounts of any consequence appearing in the cash book should be tested, in order to ascertain that they are in order.

Where counterfoil receipt books have been utilised, the counterfoils should be checked with the cash book; and where rough or memoranda cash books or cash diaries have been kept, these should be compared with the fair cash book.

It should be seen that the proceeds of all bills receivable have been duly received, and bills in hand should be examined.

The best method of verifying the balances on the Sales Ledgers, where it is suspected that amounts have been misappropriated, is for the accountant to send out a circular to the debtors, stating the amount of the balance as shown in the books, and asking for communication to be made to him direct in the event of the figure not being correct. In many cases, however, the proprietors of the business do not care for this to be done, and in any case their permission must be obtained in the first instance. Where such circularisation is not carried out, it will be impossible for the accountant to make sure that he has traced the whole of the misappropriations from this source, although these will declare themselves in due course as statements are sent out.

As regards cash payments, special care should be taken, in examining the vouchers, to note any that appear to be irregular; and it is advisable that the returned cheques and indorsements thereon should be

examined. In the case of any vouchers being missing, duplicates should be obtained. All amounts charged to the Drawing Accounts of partners should be vouched by them as being correct.

The petty cash book should be vouched and cast, as this is a very likely source of fraud. Special attention must be paid to salaries and wages, and the accountant should ascertain that the names of all the employees, and the amounts received by them, are correct.

Where the defaulting party has had access to all the books, it will be necessary for the whole of the postings to be checked, and the books cast, and a Trial Balance prepared. In checking the Sales Ledgers special attention should be paid to all allowances and bad debts written off, as entries of this nature may have been made for the purpose of concealing misappropriations of cash. Similar remarks apply to returns, and where necessary the receipt of the actual goods returned should be traced. In some cases it may be found that the defaulting party has omitted to record sales in the Sales Day Books, in order that he can appropriate the remittances received without the remedy of falsifying the books further. In order to ascertain whether this has been done, the Order Book should be tested with the Sales Day Books, to see that all orders that have been executed have been recorded, and, if necessary, reference should be made to the Goods Outwards Book. Where cash sales are made, these should be vouched in detail with whatever evidence may be available, although unless the system employed is a good one, it is a matter of great difficulty to ascertain whether irregularities have occurred.

Invoices should be vouched with the Bought Journal, in order to ascertain that none has been

passed through twice, payment in respect of the original invoice being made to the creditor, but payment for the duplicate being misappropriated by the defaulting party. Duplicates should be obtained of missing invoices, and the creditors' statements compared with the balances as shown by the Bought Ledger. The Goods Inwards Book or the Order Book should be checked with the Bought Journal in order to ascertain that all invoices relate to *bonâ fide* purchases.

If the investigation is carried out on the lines above indicated, subject to variations according to the circumstances of each case, it should be possible to ascertain the extent of the misappropriations.

§ 9.—Investigations under the Companies Act, 1948.

The Companies Act, 1948, provides for the appointment of inspectors to investigate the company's affairs in certain circumstances.

Section 164 provides that the Board of Trade may make such an appointment on the application—

(*a*) in the case of a company having a share capital, either of not less than two hundred members or of members holding not less than one-tenth of the shares issued;

(*b*) in the case of a company not having a share capital, of not less than one-fifth in number of persons on the company's register of members.

Under Section 165 the Board of Trade may appoint inspectors to investigate a company's affairs if—

(*a*) the company by special resolution, or

(*b*) the Court by order

declares that the company's affairs ought to be investigated.

The Board of Trade may also make such an appointment if it appears to them that there are circumstances suggesting—

(i) that the company's business is being conducted with intent to defraud its creditors or the creditors of any other person or otherwise for a fraudulent or unlawful purpose or in a manner oppressive of any part of its members or that it was formed for any fraudulent or unlawful purpose ; or

(ii) that persons concerned with the company's formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other conduct towards it or towards its members ; or

(iii) that the members of the company have not been given all the information with respect to its affairs which they might reasonably expect.

Inspectors appointed under either of the aforementioned sections have power to investigate the affairs of any other body corporate which is or has at any relevant time been the company's subsidiary or holding company or a subsidiary of its holding company or a holding company of its subsidiary.

The inspector has power to examine on oath all *past and present* officers and agents (including bankers, solicitors and auditors) of the company. If he wishes to examine any person whom he has no power to examine on oath, he may apply to the Court, who may order such person to attend before it and be examined

on oath. If any such officer or agent refuses to produce any book or document or to answer any question put to him, the inspector may certify his refusal, whereupon the Court may enquire into the case, and, after hearing witnesses for and against the alleged offender, may punish him as for contempt of Court. The inspector must report to the Board of Trade, who must forward a copy of the report to the company, and a further copy shall, in the case of an investigation under Section 164 at the request of the applicants, be delivered to them. Where the inspection is under Section 165, a copy of the report must be furnished to the Court. If the Board of Trade think fit they may furnish a copy of the report, on payment of the prescribed fee, to any other person who is a member of the company or of any body corporate dealt with in the report or whose interests as a creditor of the company or any other body corporate appear to the Board to be affected.

Under Section 169, the Board of Trade, after considering the inspector's report, may, where it appears that any person has been guilty of an offence for which he is criminally liable, refer the matter to the Director of Public Prosecutions, who may institute proceedings in the public interest.

If it appears to the Board of Trade that by reason of any such circumstances as are referred to in sub-paragraph (i) or (ii) of paragraph (*b*) of Section 165 (*supra*), it is expedient to do so, the Board may present a petition for the winding up of the company.

If, from the report, it appears that any body corporate dealt with by the report ought, in the public interest, to bring proceedings for the recovery of damages in respect of any fraud, misfeasance or other

misconduct in connection with the previous terms, formation or management of that body corporate, or for the recovery of any of its property which has been misapplied, the Board of Trade may bring proceedings for that purpose in the name of the body corporate.

Investigations under Section 165 are usually instituted when it is suspected that the company has been mismanaged or that the directors or officers of the company have been using the company's resources for their own purposes.

The procedure to be followed by the accountant appointed to conduct such an investigation must be determined by the terms of his instructions, but in most cases a very detailed examination of the company's books and records will be necessary. Particular attention must be paid to the verification of the existence of assets, the nature of the liabilities contracted by the company, dealings with subsidiaries, and the manner in which the profits or losses disclosed by the published accounts have been arrived at.

Under Section 172, where it appears to the Board of Trade that there is good reason so to do, they may appoint one or more competent inspectors to investigate and report on the membership of any company and otherwise with respect to the company for the purpose of determining the true persons who are or have been financially interested in the success or failure (real or apparent) of the company or able to control or materially to influence the policy of the company.

An application for an investigation under this section may be made to the Board of Trade by members of the company in the same way as under Section 164.

§ 10.—Investigations in connection with Taxation Liability.

An investigation in connection with taxation liability is usually carried out at the behest of the Inland Revenue authorities, where they have reason to suspect that complete and accurate returns of income for taxation purposes have not been made. When the investigation is in respect of tax which would otherwise be out of date, it is described as a "back duty" investigation. For a summary of the rights and powers of the Revenue in such a case the reader is referred to Spicer and Pegler's "Income Tax" (Wilson).

It is not within the province of this work to describe in detail the conduct of such an investigation, nor is it possible to lay down hard-and-fast rules as to the procedure which must be followed. So much must depend upon the nature of the business carried on, the records available, and the opportunities afforded for the falsification of records for the purpose of evading taxation liability. The accountant must bring into play not only a high degree of technical skill, but a wide knowledge of human nature and much ingenuity to arrive at the truth.

After ascertaining the period over which the investigation is to extend, the accountant should first obtain from his client such of the following documents and data as are available :—

(1) Books and audited accounts of the business.

(2) Bank pass books or statements, deposit receipts, etc., in respect of all accounts opened, and certificates from bankers as to current balances.

(3) Statements of all private assets and liabilities at the beginning and end of the period covered by the investigation.

(4) Schedules and certificates of all investments held, and names and addresses of persons in whose names they were purchased.

(5) Acknowledgments from such persons as to the assets held in their names on behalf of the client.

(6) Bought and sold notes and brokers' accounts in respect of all dealings in investments during the period.

(7) Details of any other non-business assets or property purchased and sold during the period.

(8) Particulars of any legacies, insurance maturities, or other capital receipts during the period.

(9) Particulars of any insurance policies taken out, and receipts for premiums paid thereon during the period.

(10) All interest and dividend counterfoils, and accounts of rents and outgoings of any property held.

(11) Estimates of living and other personal expenses, including cost of children's education, doctor's bills, apprenticeship premiums, gifts and other abnormal expenditure.

(12) Copies (if available) of all income tax returns made during the period, and receipts for tax paid.

Where books have been kept and accounts prepared, the investigation will follow the lines discussed in Section 2 of this chapter, special attention being paid to the possibility of sales records being omitted, purchases and expenses being inflated, and stock being improperly valued, with the object of reducing the profit disclosed by the accounts. The pass books or statements of all bank accounts kept must be obtained and analysed in the minutest detail, in order to trace the origin of all lodgments and the destination of all

payments recorded therein. All cheques drawn by the business in favour of the partners or, in the case of companies, in favour of directors or other officials whose affairs are also the subject of investigation must be traced into their private banking accounts. In the case of any cheques which cannot be so traced, the cancelled cheques, if available, should be examined. If it is found that such cheques are crossed cheques, the names and addresses of the banks through which they were cleared should be noted and enquiries made of the payees as to the manner in which they disposed of the cheques in question. Enquiries on these lines may reveal the existence of banking accounts in the names of the partners or directors or of their nominees which have not so far been disclosed to the accountant.

The exact nature of all payments from private banking accounts must be ascertained, even though the amounts involved may be small, as such payments may indicate the existence of assets which have not been disclosed, *e.g.*, a safe deposit rental, a furrier's charge for storage of a fur coat, etc. For the same reason the nature of the risks covered by all insurance premiums paid must be ascertained.

A total account for receipts and payments of cash, as distinct from cheques, must be prepared for each individual who is the subject of investigation, in order that the accountant may satisfy himself that the individual concerned appears to have had sufficient cash to meet his normal household and living expenditure. This account will be compiled as follows :—

Debit side.

(*a*) Cash drawn from bank ;

(*b*) Cash drawn from business ;

(*c*) any other cash receipts, *e.g.*, sales of assets.

Credit side.

(*a*) Cash paid in to bank.

(*b*) Lodgments in bank from sources otherwise unknown and, therefore, assumed to have been in cash.

(*c*) Payments which must have been made in cash because they were not discharged by cheque, *e.g.*, rates or other recurring known expenditure.

(*d*) Cash allowance, if any, to wife for household expenses and to children for pocket money.

(*e*) Any other known cash payments.

(*f*) Estimate of taxpayer's personal cash expenditure.

If the account prepared in this way reveals an excess of expenditure over cash received, the accountant will be forced to conclude, subject to the accuracy of any estimates in the account, that the taxpayer has received cash from sources not disclosed by him. Exhaustive enquiries into this possibility must be made, it being impressed upon the taxpayer that a satisfactory report to the Inland Revenue cannot be made with such a discrepancy unexplained.

The business accounts will then be reconstructed, full effect being given to all the information disclosed by such analysis and enquiry. It is always advisable to apply an independent check on the profits disclosed by reference to the client's style of living and capital position, as described below.

Where no books have been kept, it will be necessary to construct accounts by analysing pass books, invoices, creditors' statements, receipts for expenditure and any other available documents and data. Unless

all cash takings and receipts from debtors have been paid into the bank, it may be very difficult, if not impossible, to obtain a reliable estimate of the total amount of the sales; but if the total purchases have been ascertained, it may be possible to estimate the amount of the gross profit by reference to the percentage on purchases normally earned in the particular trade, or by adding to the bank lodgments an estimate of the amount of cash takings applied in paying for purchases and expenses, and drawn by the client for his private use.

Where the available data are so meagre that it is impossible to construct Profit and Loss Accounts, the only method of estimating the profit will be by the preparation of statements of " net worth " at the beginning and end of the period under investigation. For this purpose, exhaustive enquiry must be made to ascertain the assets possessed and the liabilities owed by the client at each date. To any increase in net worth disclosed by such statements must be added the estimated amount of the client's living and personal expenses (which, of course, must bear some relation to the style in which he lives), any losses on sale of investments, gambling losses and any other losses of a capital nature, the value of any assets which have been worn out or discarded during the period, and any other items by which the final net worth has been reduced. From the total so found will be deducted any legacies received, insurance maturities, gambling profits, profits on the sale of investments and other capital receipts, and the result may then be taken to represent the total income from all sources during the period of the investigation. From this amount must be deducted the total income from investments,

property and other sources on which tax has been paid, and the balance may be regarded as the net profit from the business for the whole period. This amount must be apportioned over the years comprised in the period on such basis as may appear to be equitable, having regard to all the circumstances, and in particular to any information that may be available as to the trend of business over the years in question.

In his report the investigator should indicate fully any deficiencies in the data at his disposal, or matters on which he has been unable to obtain satisfactory explanations, and the extent to which he is able to accept responsibility for the accuracy of the figures disclosed by the accounts.

APPENDIX

RECOGNISED BODIES OF ACCOUNTANTS

The following bodies of accountants established in the United Kingdom have been recognised by the Board of Trade for the purposes of Section 161 (1) of the Companies Act, 1948 :—

The Institute of Chartered Accountants in England and Wales.

The Society of Incorporated Accountants and Auditors.

The Association of Certified and Corporate Accountants.

The Society of Accountants in Edinburgh.

The Institute of Accountants and Actuaries in Glasgow.

The Society of Accountants in Aberdeen.

The Institute of Chartered Accountants in Ireland.

A member of the above bodies is accordingly qualified, so far as the provision is concerned, for appointment as auditor of a company.

Persons desiring to be qualified for appointment as auditor of a company under the provisions of Section 161 (1) (*b*) may apply for authorisation to the Assistant Secretary, Board of Trade, Insurance and Companies Department, Romney House East, Tufton Street, S.W.1.

EXTENSION OF PROVISION OF COMPANIES ACT, 1948, TO UNREGISTERED COMPANIES

Under the Companies (Unregistered Companies) Regulations, 1948, S.I. 1948, No. 1398, the provisions of the Companies Acts as to Prospectuses, Allotment, Annual Return, Accounts and Audit, are extended to apply to certain unregistered companies (including chartered companies trading for profit and certain public utility companies formed under private Acts of Parliament).

In the case of most of the companies concerned these provisions will apply as from 1st October, 1948, and accounts laid before a general meeting of such a company held on or after that date will have to comply with the new provisions. In the case of companies carrying on water, hydraulic power or pier undertakings, the provisions in question will not apply until 1st July, 1949.

The provisions of the Companies Acts as to investigations and as to the Register of Directors and Secretaries will apply to all the companies concerned as from 1st July, 1948.

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